A short history of economic thought

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Preface

This book has been prepared initially as a textbook for undergraduate students at the University of Asmara, Eritrea. The study of history of economic thought is interesting and exciting for both the students and the instructor. The subject becomes more interesting if the contribution of the writers are given along with their backgrounds. This would enable the students to put economic issues in perspective. With this in mind, the book covers major writers and schools of thought from ancient times to present day. The period covered is broad and there are far more ideas than can be covered within the scope of this book. Thus, select lists of writers, representing mainstream economics have been chosen.

This book is an outcome of my teaching experience of the course, *History of Economic Thought*, at the University of Asmara during the past ten years. Although there are several books written on the subject that could suitably serve the purpose, it discernible that not all the desired books can be made readily available to our students. I am hoping that this will assist somehow in bridging the gap for this course.

The book is primarily prepared for the use of undergraduate students at the Department of Economics and Finance, but other staff and students could also benefit from it. Although there is no watertight compartmentalisation in real life, an attempt has been made to put writers falling under similar schools of *thought* together. Consequently, although there are twenty chapters in this book, some chapters are longer than others because there are more issues or personalities coming under that topic. However, attempt has been made to include everyone or everything that were considered important enough to warrant inclusion. For further explanation, the reader is advised to follow the list of books shown in the reference section. In order to provide current information on current affairs in the field of economics, the list of Nobel Prize laureates are given at the back of the book with a brief citation of the work for which they were given recognition.

The publication of the book was made possible under the joint collaboration project between the University of Asmara in Eritrea and the University of Groningen in the Netherlands, which has been going on since 1996. I would like to record my gratitude to the University of

Groningen for allowing me access to the University facilities including access to its rich library; the Office for International Cooperation for facilitating my trip and answering my queries; the University of Asmara for allowing me to take a three-month research leave to finalise my work. I would like to thank my students for giving me feed back during the years that I taught the course and my colleagues for supporting me in many ways.

While preparing this book, many friends and colleagues have supported me. Some have encouraged me to write this book; some assisted me in proofreading, while others gave moral support. I take this opportunity to thank you all. I am also grateful to many friends and colleagues in the Netherlands for introducing me to the Dutch culture and hospitality: some hosted me at their place, while others had encouraging words. My especial appreciation goes to Dr. Pieter Boele van Hensbroek, for his invaluable assistance in times of need, and Ms. Dicky Gjaltema and Mr. A. Bijlholt for hosting me during this summer.

In spite of the help provided there are bound to be typographical and other errors. These are my responsibility.

Tesfa – Yesus Mehary
Groningen, October 2002

To my Family, with love and appreciation

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1.1 What is Economic Thought?

As human knowledge accumulates, it is analysed and categorised into different sciences. Economic science is also a result of the same process and includes doctrines and generalisations, which deal with economic phenomena of our life. Economic science, like other sciences, has had to undergo a process of evolution and is the result of innumerable contributions by various thinkers. In many cases, specific contributions were recognised during the very lifetime of their contributors. In some cases the views of these thinkers had a great impact upon that moulding of future patterns of economic thought. The role played by different thinkers in the process of its evolution has been uneven. Some thinkers appeared like luminous stars in the sky and dazzled everything in sight, while others appeared rather dim. However, even when the contributions by some thinkers were not very spectacular when they were made, every contribution has its own place and relevance in the development of economic science and in improving our comprehension of economic phenomena[1].

At the outset, it is essential to clarify the similarities and difference between economic history, history of economics and the history of economic thought because they appear to be the same. Economic history, or industrial history as it is also called, concerns itself with the history of commerce, manufacture and other economic phenomena, dealing *objectively* with the ways in which men get their living. History of economics and history of economic thought are concerned with *subjective* matters dealing, for the most part, with ideas men have concerning economic facts and forces. The history of economics deals with a science – with a body of classified knowledge based upon the establishment of certain uniformities in economic life, or the tendency of certain results to flow from given causes. It is limited to times in which economic ideas have become distinct, unified, and organised; it is a history of economic thought[2].

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[1] H.L. Bhatia, *History of Economic Thought,* 4th edition, New Delhi: Vikas Publishing House, Pvt., Ltd., 1978. p. 1.

[2] Lewis H. Haney, *History of Economic Thought,* 4th edition, New Your: The McMillan Company, 1949, pp. 3-5.

The history of economic thought is broader than the history of the science; it may properly be divided into two parts, one of which takes up the origin and development of economic ideas prior to the existence of any distinct and separate science; while the other begins with the rise of political economy, or the science of economics. The history of economic thought may be defined as a critical account of the development of economic ideas, searching into the origin, interrelations, and manifestations. The close relationship between economic history and the history of economic thought is at once to be emphasised. That the thoughts of men depend largely upon their surroundings, no one doubts. The history of economic thought, then is an essential part of general history, both explaining it and being explained by it[3].

Ordinarily, economic thought would be taken to cover the set of theories, doctrines, laws and generalisations, and analyses applied to the study and solution of economic phenomena and problems. It should be noted, however, that the specific contents of economic thought have normally commanded an uneven prominence some attracting more attention than others; and that the overall composition of economic thought is also subject to a continuous variation. Economic thought is not a given and fixed set of economic theories or tools and techniques of analysis; rather it is a dynamic science. It has been and is vibrant from intellectual discourse, *but not a settled body of principles*[4]. It brings forth a body of generalisations, which involve cause-effect relationships. But from amongst the set of causal forces at work, the relevant ones have to be sorted out for the problem at hand; and similarly on the side of effects a sifting process has to be undertaken. These tasks admit of a difference of judgement and opinion. Since human society is a complex phenomenon, a very large number of causes are likely to be at work in most cases and different investigators could very well differ as to the choice of the most *relevant* causes at work. Also investigations could unearth those forces which were hitherto thought irrelevant or not of particular importance. Moreover, the identification of the casual forces at work does not imply that these causes would not change till their final outcome is encountered. Over time, the very roles of specific forces are likely to undergo a change. The responses of economic units (individuals, firms, governments, etc.) would vary from one situation to the other, in view of the prevailing moral, political, religious and social philosophy as well as the institutional framework of the society[5].

[3] ibid., p. 5.
[4] Robert Ekelund and Robert Hebert, *A History of Economic Theory and Method,* 3rd edition, New York: McGraw-Hill Publishing Company, 1990, p. 4.
[5] Bhatia, p. 2.

An economy is a dynamic phenomenon and therefore economic science is a dynamic one. The result is that economic science is always undergoing a change. Over successive time intervals, specific sets of economic ideas, theories, doctrines, tools and techniques acquire recognition and acceptance implying thereby that in different contexts we have different systems of economic thought. The study of the history of economic thought, therefore, automatically becomes a study of these various systems of economic thought. According to Haney the study of economic thought may be defined as *a critical account of the development of economic ideas, searching into their origins, interrelations, and manifestation*[6]. At the beginning most economic ideas and doctrines have been in a fluid form, however, with the passage of time, there has been a development in the concepts and tools and techniques of analysis. Old economic concepts acquired greater precision and new concepts were continuously introduced to cope with the emerging theoretical and practical problems. *Along with the development of concepts there has also been a sharpening of the tools and techniques of analysis*[7]. In this connection, we should keep in mind the distinction between economic ideas as such and economic science or economics proper. Economic ideas have been there since time immemorial, but it is only recently that they assumed the form of a system of thought, which may be termed economic science or economics.

References to economic questions are scattered almost everywhere in old literature. Economic analysis has yielded a rich and extensive history since its formal inception over two hundred years ago.[8] Economic thought is a body of economic ideas and generalisations, which can be seen to *belong* to each other. There are theoretical underpinnings of the economic investigations and policy prescriptions. There is a logical reasoning involved in the process of arriving at conclusions, and there is also an aspect of abstract theorising. It is only at this stage of formation and cohesion that economic ideas collectively become economic thought. It is not of course necessary that the economic ideas in a system of economic thought must be conforming to each other or that they must belong to one main body. Rather it is the overall thinking process, which lends economic ideas the colour of mutual association and belonging and therefore brings forth the phenomenon of economic thought.

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[6] Lewis F. Haney, *History of Economic Thought*, 4th ed., New York: The McMillan Co., 1949, p.4.
[7] Bhatia, p. 3.
[8] Ekelund and Hebert, p. 3.

1.2 Lack of Agreement in Economic Thought

There are several reasons to believe that we should not expect a uniformity of conclusions and opinion amongst economists on issues of either theoretical or practical importance. Bhatia has enumerated the following:[9]

(a) Economics is a social science in which controlled experiments are next to impossible. Accordingly there is always a possibility of difference of opinion regarding the choice of relevant causal forces and the process of their interaction. In the same way, in abstract theorising, the choice of the relevant factors, forces and limiting assumptions are important.

(b) There are chances that differences would exist with reference to the assessment of facts, especially when they are mixed with other ones. Determining the precise direction and strength of a particular force is a matter of investigation, judgement and opinion. Relevant phenomena are investigated and estimated with the help of available data and tools and techniques of analysis. All these things are subject to a modification. Data keep on changing; old data are replaced or supplemented by new ones. Similarly, there is a constant improvement in the tools and techniques of analysis.

(c) Economic analysis admits of a wide variety of methods. As a result, even with given tools and objectives, the method of analysis may vary from one analyst to the other and yield non-identical results.

(d) Apart from these reasons, differences arise on account of the purpose for which an economic investigation is being undertaken. This is more so in the case of practical problems and their solutions. The cause-effect relationship between different forces would be assigned to suit a particular philosophy and purpose.

(e) Another reason for the divergence of opinion arises on account of the materialistic and idealistic attitudes of the economists. Economists, in the ultimate analysis, are as much human beings and individuals as anyone else, and they are quite frequently swayed by the final conclusions, which they would like to press forth.

[9] Bhatia, pp. 5-7.

1.3 Why Study History of Economic Thought?

Well, why do we study the history of any *science*? Current work will preserve whatever is still useful of the work of the preceding generations. It appears that concepts, methods, and results that are not preserved are presumably not worth bothering about. Why then should we go back to old authors and rehearse outmoded views? Cannot old staff be safely left to the care of the few specialists who love it for its own sake?

Schumpeter[10] provides the following reasons:

First, teachers and students who attempt to act upon the theory that the most recent treatise is all they need will soon discover that they are making things unnecessarily difficult for themselves. Unless that recent treatise itself presents a minimum of historical aspects, no amount of correctness, originality, rigour, or elegance will prevent a sense of *lacking direction and meaning* from spreading among the majority of students. This is because the problems and methods that are in use at any given time embody the achievements and carry the scars of work that has been done in the past under entirely different conditions. The significance and validity of both problems and methods cannot be fully grasped without knowledge of the previous problems and methods to which they are in response.

Second, our minds are apt to derive new inspirations from the study of the history of science. Some do so more than others, but there are probably few that do not derive from it any benefit at all.

Third, the highest claim that can be made for the history of any science or of science in general is that it teaches us much about the ways of the human mind.
Fourth, it stands to reason that the preceding arguments, apply to the science of economics. The economics of different epochs deal with different sets of facts and problems. This fact alone would suffice to lend increased interest to doctrinal history.

Thus, it is always helpful to have some knowledge of the history of thought of the subject one is interested in. Every science grows and evolves over time and during the process of its refinements and expansion attracts numerous debates and controversies which not only relate to the subject matter of the discipline itself, but also to its application to the problems of

[10] Joseph A. Schumpeter, *History of Economic Analysis,*[12th Printing]. London: Allen and Unwin, 1981, pp. 4-6.

actual life. As such, a study of economic thought enables a student of economics to realise that the current fluidity in economic theories and inconclusiveness of various branches of thought are not something to be disturbed about; it is not indicative of any weakness of the science, but it is a normal phenomenon with any science.

The study of economic thought lends a perspective to the subject and enables the student to have a wider view of what he is studying. It enables him to realise that economics, as a science, is a comprehensive whole and those individual theories, tools and techniques have their meaning, importance and rationale only in the context of that overall totality. In the absence of knowledge of the history of the economic thought, a student is apt to be misguided into believing that the theories he is studying are either final or have no relevance at all. This is more so because each theory is presented on the basis of certain assumptions and in the context of a given economic system with all the implied institutional factors. If a student gets a feeling of the finality of a theory, he may not feel free to use his analytical abilities for a deeper probe of the same. Alternatively, he may be impressed by the abstraction of a theory and the unrealistic assumptions upon which it is based and might therefore come to the conclusion that every abstraction in economics is an equally useless exercise.

Moreover, knowledge of economic thought enables a student to realise that economics is a dynamic science. On the one hand, economic science moves forth on account of the fact that new tools, techniques and concepts are being added to the armour of the economists, and on the other hand, additional economic phenomena are being investigated and analysed. Likewise, the very dynamism of the world economies lends an element of dynamism to economics also. By studying economic thought a student is equipped to assign to current controversies and debates the place they deserve. He is not bogged down or disheartened by the heated controversies and differences of opinion. These things appear to him signs of life within the science of economics and he knows that there are indicators of continuous development and refinement.

Furthermore, a study of the history of economic thought brings home the fact that economic aspects are only a part of the totality of our life. Economics is only one of the social sciences, and as such it does not explain the total behaviour of a society, nor does it provide a total solution to any problem. There is a need to study economic problems in the context of their overall social framework and the interdependence of economics with other social sciences should not be lost sight of. This

realisation also enables the student to appreciate the fact that similar problems would not necessarily yield similar solution in the hands of different economists. Economists are also human beings living in a society, and the solutions, which they offer, must be conditioned by the totality of their existence and views. There would be subjective elements involved in the interpretation of economic phenomena and so they would propose different solutions according to their personal views. An economist with leftist views would advocate solutions, which would be different from the ones advocated by an economist of rightist views. Some solutions would take note of the administrative and political difficulties in implementing the same, others would not. In this way the contribution to economic science made by any individual economist or a school of thought is to be appreciated only in the context of the underlying philosophy.

II. ANCIENT ECONOMIC IDEAS

2.1 Introduction

The origin of economic thought is lost in the past. In its simplest form it must have always existed wherever thinking beings sought to gain a living. Economic ideas of any definiteness find their earliest expressions, however, in rules of conduct or moral codes formulated by priests or lawgivers. These moral codes, like the Mosaic Law, for example, in dealing with man's place in the world, with life and death, and the end of existence, necessarily touched upon economic matters[11]. Thus, our economic heritages as obtained from these simple communities are rudimentary ideas about economic relationships within themselves. Also, most of these ancient economic ideas are transmitted to us as an embodiment of religious teachings, codes of law, and moral exhortations.

On the other hand, clear evidence exists of a thriving and relatively sophisticated civilisation in the proximity of the Nile River more than three thousand years before the birth of Christ. The Egyptians, it would seem, with a lineal and quasi-orderly civilisation of more than thirty four hundred years must have produced economic ideas of some interest. The Egyptian economy was, at least for a massive amount of resources, characterised by *command-directed* production and distribution. Also, the thriving trade with other nations, albeit in barter, coupled with the early development of hieroglyphic writing and the Egyptians' penchant for record keeping, would seem to present a fertile ground for economic thought. The engineering and scientific achievements of the Egyptians beginning with the period of the Old Kings (2686 -2181 B.C.) are incredible achievements of their genius. Hence, it might be an oversimplification, at its best or a rush assumption at its worst, to consider that these Egyptians were totally unsophisticated in economic matters, or primitive in their perceptions.

Similarly, other ancient civilisations had flourished in Asia but these have not been examined in detail for their contributions to economic thoughts. These civilisations were also taking place some three thousand years B.C. Furthermore; it appears the Babylonian civilisation left us no economic legacy worthy of note. Thus, whatever economic ideas we have of their civilisations are those, which are embodied in the Code of Hammurabi as

[11] Haney, p. 28.

revealed by modern archaeological discoveries. The Code contains a detailed regulation for economic practices representing, among others, a system that regulated and governed the economic relationships of the Babylonian community. Nevertheless, western civilisation has its origin not in ancient India, Babylon or Egypt, but rather in the civilisations of the Hebrews of biblical times and the Greeks[12] of the classical age, who in turn must have benefited greatly from earlier civilisations.

2.2 Biblical Communities

As the primitive Jewish tribes gradually evolved from tribal communities into a society of more sophisticated social structure, the attention of the Hebrew prophets turned against the economic abuses that ensued from the developed trade. The Bible, which, among others, is regarded as the reflection of the ancient theocratic state of the Jews, contains many injunctions against greed[13], and exhortations against overemphasis on material wealth. The people were enjoined to use justice and mercy in their every economic relationship. Some of the admonitions of the Hebrew prophets witness that, in the evolution of the Jewish society, from a primitive tribe to a more sophisticated commercial order, a good number of measures were developed or adopted with a view to protect their society form exploitation and other abuses of an economic nature.

For instance, it was considered improper to charge interest for money lent to someone who was considered poor. *If you lend money to any of my people with you who is poor, you shall not be to him a creditor*[14]. Also, *upon a stranger thou mayest lend upon usury, but unto thy brother thou shalt not lend upon usury*[15]. Such statements, while condemning the practice of charging interest on loans, focus partly on the sin of exploiting the *poor* through lending money at interest and, more generally, on the sin of one Jew levying interest on another.[16]

[12] However much scholars differ as to the extent of the contributions made by Asia and Africa to Greek culture, it may safely be said that such contributions were considerable. Haney, 1949:56.
[13] It is interesting to note that both the Hebrews and the Hindus had careful regulation against false weights and measures, and against adulterations. Haney, 1949:45
[14] The Old Testament, *Exodus 22:25*
[15] ibid., *Deuteronomy* 23:20.
[16] Similar passages are also found in the books of the Old Testament: Leviticus 25: 25-27; Psalms 15: 5 and Ezekiel 18: 13.

Stressing on the good life, one of the unique features of Biblical law required the periodic liberation of slaves of the Israelite race. The slaves were expected to serve for six years and to be freed on the seventh year and that they were to be liberally provided with food and other goods that would enable to start out life on their own[17]. The humane treatment of slaves was also spelt out clearly. The seventh year was also the year in which debts were to be cancelled[18], indicating profound concern for the quality of life that was not to be burdened unduly.

Among the Much emphasis is given to the dignity of labour and worth of human labour. Labour is considered a blessing that gives life.[19] Just as toil is honoured idleness is condemned.[20] Here it may be noted that the positive attitude to manual labour is at variance with the thinking of ancient philosophers of Greece.

2.3 Ancient Greek Economic Ideas

Greek society underwent a more or less similar evolution to those of the Biblical communities. From being a tribal society at the beginning it evolved into a society of largely self-sustaining household in which absolute political power resided with kings and priests. Gradually a landed aristocracy developed, in which peasants and artisans were almost totally excluded from the possession of the soil. War captives flowed in considerable number into the Greek society to form a separate class of slaves assigned to perform manual labour.

The development of navigation and commerce of the Greek *city-states* endowed great wealth on merchants who become a class powerful enough to challenge the political power of the landed aristocracy. The clash of the two classes, which subsequently developed into a serious conflict, culminated in an almost total collapse of the hereditary ruling class and the victory of the wealthy class of merchants. In fact, the democracy, which was practised in Athens, was to a large extent, an expression of the interests of the commercial class. The new state of things in the Greek *city-states*, and particularly in the Athenian State, was complicated by the existence of mass of slaves and impoverished peasants and artisans. Of course, artisans and slaves had no place in such a democracy and slaves

[17] Deuteronomy, 15: 12.
[18] Deuteronomy, 15: 2
[19] Proverbs, 10: 12.
[20] Proverbs, 6: 6-11; 24: 30-34; Ecclesiastics 10: 18.

were not only deprived of civil and other rights, but were not even given the status of citizenship. The new socio-politico-economic set ups compelled lawgivers, politicians and philosophers to devise and develop principles for the regulation of the new economic relationships from which evolved the changing society.

The development of a new social condition within the Athenian State caused many writers, politicians and social thinkers to analyse the situation and to propose appropriate solutions. Among these thinkers some have yet to be acknowledged[21]. Here we deem it worthily to mention, four celebrated names: Hesiod, Plato, Aristotle and Xenophon who tackled the social problem from both the economic and political standpoints. Hesiod, whose ideas were presented orally during the eight century B.C., has noted that scarcity does not arise from a human condition concerning limited resources and unlimited desires[22].

Four events stand out in the early economic history of Greece that has profound effects on the economic structure of the early *city-state*. These were the adaptation of the Phoenician alphabet in the ninth century B.C.; the founding of Greek colonies in the Mediterranean Sea and the Black Sea late in the eighth century B.C.; the invention of coined money in Lydia in Asia Minor in the seventh century B.C., which soon spread to Greece; and the rise of lending at interest[23].

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[21] S. Todd Lowry [*The Archaeology of Economic Ideas.* Durnham, N.C.: Duke University Press, 1987] has identified seminal contributions to modern economic analysis by the Greek writer Protagoras. He asserts that Protagoras's man-measure doctrine is the parent idea of both the labour theory of value and the idea of subjective individualism. He also claims that Protagoras anticipated two of the most basic elements of modern economic theory: the way the market maximises utility through its function of allocating resources and the use of hedonistic measurement in the evaluation of choice. Landreth and Colander, p.26; and as Cited in Ekelund and Hebert, p. 19

Whereas Plato was an absolutist, Protagoras (c. 480-411 B.C.) was a relativist. He held that there was no objective truth, only subjective opinion. This subjectivism is exemplified in the famous maxim attributed to him. *Man is the measure of all things*. In other words, although truth cannot be discovered, utility can. According to Protagoras it is up to the citizen of a state to decide what constitutes social welfare and how to achieve it. As against the absolute authority of Plato, Protagoras extolled the democratic process. He believed in common sense as against science, and in the practical social experience of mankind as opposed to the doctrines of moral and political theorists. Not surprisingly, Plato was one of his critics.See; Ekelund and Hebert, pp. 18-19.

[22] ibid., p.26

[23] Henry William Spiegel, *The Growth of Economic Thought,* Englewood: Prentice-Hall, Inc., 1971. pp. 8-9.

Plato (c. 427 - 347 B.C.)

This philosopher who lived during the maturity of Athenian culture in the fourth century B.C was a disciple of the great Greek philosopher, Socrates. His main political and economic ideas are found in the *Republic,* written about 400 B.C. and *Laws.* The ostensible purpose of the *Republic* is to give an answer to a question that has haunted philosophers throughout the ages – what is justice?[24].

Though essentially an aristocrat, Plato did not support his class. Moreover, he disliked Athenian democracy, because he abhorred the excesses of commercialism with its entailing corruption, misery and general degradation. He looked down, as did his fellow aristocrats, upon both manual labour and the pursuit of wealth, but exalted the warrior, the statesman and those responsible for agriculture. His spiritual and romantic revolt both against the state of things in Athena's democracy and the brutal and tyrannical rule of a hereditary class such as in Sparta, in which the masses were ruled mercilessly, inspired him to produce his. This classical masterpiece however contains romantic and highly idealised concepts and so it, is referred to as *utopia.*

In *The Republic* Plato proposed the establishment of an ideal *city-state*, which would inaugurate a new social order: communism. In such an ideal state there should be two classes: the rulers and the ruled. The former would be divided into guardians and auxiliaries; the latter would consist of peasants and artisans or craftsmen who ought to be excluded from political rights. The exclusion from political rights of the ruled masses was based on Plato's belief that no member of these masses, devoted as they were to menial work and the manual occupation of production and exchange of wealth, could have the ability to manage the high duties of citizenship and the capacity to run a government. The members of the ruling class must be selected from among teen-agers and set apart from early childhood, properly educated not only in philosophy but also in the arts of war, since it would be their duty to protect the state from external attacks and internal disorders. At the age of thirty, they would have to pass an examination and the successful candidates would be the guardians or the philosopher-kings. Those who could not pass the examinations would remain auxiliaries concerned with general administrative duties. Both the guardians and the auxiliaries were not to posses any property nor have an income beyond that which would be necessary for their

[24] Spiegel, p. 14.

maintenance. Plato believed that the proposed system would produce ideal rulers - capable and honest rulers.

Plato argued that these rulers, through a well-devised educational system were free from the degrading pursuit of wealth[25], and hence they would be capable of dedicating themselves to govern their community with a rule of reason. Such highly idealised concept of rulers made Plato ignore the corrupting effect of absolute power and the economic aspect of a caste system. His *utopia* ultimately turned out to the well suited as an apologia for an actual oligarchy.

Plato's contributions to the economic field concepts covered various topics including division of labour; production as basis of the wealth of the state; the theory of money; and communal ownership of property.

The Division of Labour - Plato argued that the city-*state* arose because of the division of labour, which came about from the natural inequalities in human skill and the multiplicity of human wants. Each man specialises in a given field in which he shows special proclivity which amounts to saying that specialization causes men to be no longer self-sufficient but inter-dependent one on another. Specialization, in turn, makes a commercial organization necessary. Two thousand years later the same concept was to serve as a cornerstone of Hutcheson, Hume and Adam Smith's system of economics[26]. While for Plato the all-important fact is human inequality, which gives rise to specialisation, to Smith, the aspect of the matter to stress is the improvement in productivity that results from specialisation[27].

Production as the Basis of State or Communal Wealth - Plato regarded production of both agricultural produce and the products of craftsmanship as the basis of communal wealth. He laid special stress on agriculture and craftsmanship, which according to him, should be given such attention, as they constituted the wealth of the community and the state.

[25] In the **Laws**, which, was written by Plato when he was older, he considered that the fall of the ideal state would invariably be related to the accumulation of wealth and to the inequalities and cleavages created thereby. The elimination of private property from the ruling class is thus the cornerstone of Plat's system. See, Spiegel, p.19.
[26] Haney, p. 57; Spiegel, p. 15.
[27] Spiegel, p. 15.

It may be pointed out that Plato was averse to a large city[28]. The size of a city, he believed, must be large enough to provide opportunity for veering talents, but not so large that the citizen would not know one another or that it would be clumsy to administer. In fact, for Plato the city was to consist of a limited number of citizens. If the number began to decrease from 5,040, prizes may be offered to encourage a growth of population; if there were excess, colonies would be established.[29]

The Theory of Money - His aversion to the emphasis on gain seeking which accompanied the rise and development of commerce led him to discuss the nature of money. Money, he said, is sterile, that is, incapable of producing and hence it should be regarded only as a medium of exchange. He would have no gold nor silver for the private man, but only domestic coins to be used for hirelings and the like, but he thought that the state should have a common Hellenic currency for the use of embassies, expeditions and journeys[30].

Communal Ownership of Property - Plato, though against the tyrannical rule of the landed aristocracy, looked down on manual labour and the pursuit of wealth. His dislike of the pursuit of wealth led him to conceive of an idealized state in which private property would be abolished and replaced by communal ownership[31].

Plato's rejection of private property, his disdain for commercial activities, his proposals for the breeding of human beings, his lack of respect for the private spheres of individuals – would place him as a fascist, and yet in the *Laws*, he expressly and at great length rejects the notion that a victorious war is the highest social ideal. Instead, he wants the community to be organised for external and internal peace, insisting that this, rather than war, is the highest purpose[32].

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[28] Population growth was checked by late marriage and a high infant mortality rate, and when the population size increased and created pressure it found out outlet in emigration to overseas settlements rather than in increased production. Spiegel, p.9.
[29] Haney, p. 60.
[30] ibid., p. 66.
[31] It is worthwhile to note that Plato had desired a complete communism embracing not only property but also wives and children. His ideal state is characterised by a community of wives and children, partly with the idea of eugenics and control of population, such that the number of people residing in a nation state will not exceed the ideal number. Aristotle was opposed to Plato's communism of wives, and he did not go to any great way with him as to property.
[32] Spiegel, pp. 21-22.

On the other hand, another Greek Democritus (c. 460 – 370 BC) had not only argued for a division of labour but also advocated for the private ownership of property as an incentive that would lead to greater economic activity[33].

Aristotle (c. 384 – 322 B.C.)

This renowned philosopher, who was a disciple of Plato, approached the subject of economics in a more systematic manner than did his teacher. In his celebrated book *Politics* written around 350 B.C. he criticized Plato's ideal Republic, especially the extreme form of unity or solidarity of the state. He strongly opposed the communality of property proposed by his teacher and based his attack almost entirely on the "incentive" argument. Communal property, he maintained, would not be looked after as carefully as private property. Moreover, he argued, that quarrels would inevitably take place because men are unequal by nature in skill and industry, were not differentiated by varying opportunities of enjoyment. Aristotle did not propose the abolition of private property but the adoption of a more enlightened and liberal use of it.

Aristotle had proposed the establishment of an ideal city based on reason and benevolence. In his *city-state*, like that of Plato, the citizens were divided into rulers and ruled. The former includes the military class, the statesmen, the magistrates and the priesthood. These functions are to be assigned according to age: young citizens who, by nature and by virtue of their ages, are strong, should form the soldiery; the statesmen and the magistrates should be recruited from among those in the prime of life; and the class of aged citizens should supply the membership of the priesthood. Farmers, craftsmen and labourers should form the ruled class; the basis of *state* still remained slavery. Aristotle is famous for his strong apologia on the institution of bondage, as he believed that some people were slaves by nature. Accordingly, slaves were to be recruited from those of non-Hellenic origin.

Aristotle's important economic concepts are found in his *Politics*, some in his *Ethics* and a few in his *Topics* and *Rhetoric,* in the latter he discusses the art of reasoning. His scope of economics included analysis of exchange, and the theory of money. The merit of his discussion rests upon the fact that his arguments were based on logical analysis.

[33] Landreth and Colander, p. 27.

The Definition of the Scope of Economics - According to Aristotle, economics is divided into *economy proper,* which was the science of household management and *the science of supply,* which was concerned with the art of acquisition. From the management of household there is conceptually distinguished the *art of acquisition*: the former has the function of using what the latter provides[34]. There are different methods of acquisitions corresponding to different ways of life: pastoral, farming, fishing, hunting and piracy. The practice of these arts of acquisition yields what nature has provided for man – a true wealth that is limited in quantity, which is an end in itself.

The Analysis of Exchange - The science of supply led him to analyse the art of exchange through which the needs of the household are increasingly met. He distinguished between two forms of exchange: the *natural* forms and the *unnatural* forms of exchanges (i.e. the art of money making). The former is merely an extension of the economy of the household designed for the satisfaction of men's natural needs. It arises from the existence of varying stocks of goods and the enlargement of the association of men beyond the confines of the household. The unnatural form of exchange is the exchange with a scope of making profits and, therefore, money. Natural exchange implied an exchange of goods of equal value, whereas unnatural exchange is carried out with the objective or making profit and it is, therefore, trade. The worst form of money making, Aristotle argued, was that which used money itself as the source of accumulation: *usury*.

Aristotle, not only approached the subject of economics in a systematic and logical way, but he was the first economist who made a correct differentiation between the two aspects of the value of a commodity: the *face value* and the *exchange value*.

The Theory of Money - Aristotle's theory of money consisted in further elaborating Plato's definition of money. He showed, through a lucid description, how the inconvenience of barter led to the development of indirect exchange, i.e. the replacement of barter economy by money economy; how measurement by size and weight was replaced by coinage, and how trade, for its own sake, and the pursuit of money-making, arose.

Thus, according to Aristotle, money has a conventional rather than a natural origin. He accepts his teacher's concept that money should be

[34] Spiegel, 1971:25

regarded as a medium of exchange. However, he takes this definition of money further. He recognises the additional functions of money; that money is a standard of value, namely, it serves as the measurement of the values of different commodities; and that money functions as the store of value, that is, it serves the functions of deferred payments.

Private Property - Although Aristotle frowned on moneymaking and exchange transactions at moneymaking, he defended private property and opposed the restrictions imposed in the maximum amount of property to be held, such as Plato had recommended. Plato had argued in favour of the abolition of private property, at least from the ruling class, to attain perfect unity of the state, but Aristotle warned that such unity runs contrary to human principles. He stated that it runs against the principles of diversity, reciprocity and self-sufficiency. Aristotle found that private property was superior to communal ownership of property in five events: progress (private property is more productive); peace (common property is not conducive to social peace); pleasure (private property gives pleasure to the owner); practice (there is no empirical example to draw from) and philanthropy (people may be motivated to do something good for society without compulsion)[35].

Justice - The principle of moderation has been a central in the thought of Aristotle. It underlines Aristotle's concept of virtue, where the virtuous man will practice courage because by doing so his action will hold middle ground between certain excesses. He distinguished two types of justices; distributive and corrective. Distributive justice deals with sharing of wealth and honour in society, while corrective justice relates to the judge's correction of wrong doing by means of reducing the gain of one party and the loss of the other[36].

Aristotle also discussed justice in exchange but it is not clear. There have been differences on its interpretation. An isolated case of the justice in exchange includes the case of monopoly, which he discussed as part of different methods of acquisition[37].

Xenophon (c. 420 – 355 B.C.)

Xenophon must be one of the economists as his writings are a paean to

[35] Spiegel, pp. 28-29.
[36] ibid., pp. 30-31.
[37] ibid., p. 30.

the science of administration[38]. This disciple of Socrates was an eminent historian and soldier, who couched his ideas in terms of the individual decision maker. His *Oeikonomikos* explores the proper organisation and administration of private and public affairs, whereas his *Ways and Means* prescribes the course of economic revitalisation of Athens in the middle of the fourth century, BC. Viewing the material environment as fixed, Xenophon concentrated on human capacity, directed by good leadership, as the chief variable of administration[39].

A good manager strives to increase the size the economic surplus of whatever unit he supervises (e.g. family, city, state). For Xenophon, this is accomplished through skill, order, and one of the most basic economic principles, the division of labour. The division of labour, as noted above, has become a linchpin of economic growth in the writings of Adam Smith, but its important economic implications has been recognised in antiquity. Xenophon attributed an increase both the quantity and the quality of goods to the principle of division of labour. Furthermore, he carried the discussion into an analysis of the relationship between population concentration and the development of specialised skills and products. This insight lies at the bas of Adam Smith's famous dictum that specialisation and division of labour ae limited by the extent of the market[40].

Xenophon's leader – that exceptional individual, who organises human activity - confronts the forces of nature than the forces of competitive economy. Although the leader is motivated by self-interest, acquisitive behaviour as such is not considered *natural*. Rather, the economic process consists of intelligent man using perception and reason to extract from nature what is necessary to fulfil human needs and to avoid discomfort. This active rational pursuit of pleasure and avoidance of pain was formally recognised in the doctrine of *hedonism*, which was part of the larger Greek consciousness[41].

[38] Citing the noted British economist of the nineteenth century, Philip Wicksteed, who wrote that economics …*may be taken to include the study of the general principles of administration of resources, whether of an individual, a household, a business, or a State, including the examination of the ways in which waste arises in all such administration,* Xenophon is considered one of the earliest economists. Ekelund and Hebert, pp 15-17.
[39] ibid., p. 16.
[40] ibid., p. 24.
[41] ibid., p. 19

The idea that it is the consequence of pleasure produced by a good, and not the good itself, lies at the centre of utility theory in economics. Xenophon developed the idea of subjective utility further in his dialogues: *for all things are good and beautiful in relation to those purposes for which they are well adapted, bad or ugly in relation to those for which they are ill adapted.* This resort to subjective evaluation in the measurement of good versus bad was an important premise of Greek thought[42].

2.4 Ancient Economic Ideas of Rome

The economic contribution left by Rome to posterity is rather meagre in spite of the greatness and splendour of her empire. Roman history was studded with economic problems, but no thought was given to speculation about economics[43]. One possible answer to this enigma is that the social structure of ancient Rome was not congenial to purely intellectual interests. This empire, which has constructed major engineering works, such as bridges, aqueducts, roads and temples, and a legal legacy to testify to her greatness and high degree of civilisation, appear to have been incapable of producing social thinkers of high calibre.

Rome had its beginning in small agricultural communities with a primitive type of trade and a rigid division of social classes. From bottom up, the structure consisted of slaves, peasants, artisans, and traders, capped up by a civil and military aristocracy. Although the aristocracy nurtured a considerable interest in Greek philosophy and art, it did so more as avocation than vocation, with predictable result that little serious analytical advance in economics occurred.

The one great achievement of Roman society was the law. From a social standpoint, it was the crowning glory of one of the greatest empires in the history of the world. Roman law was divided into a civil law that applied only to relations between citizens (*jus civile*) and a kind of common law that ruled commercial and other relations between non-citizens or between citizens and non-citizens (*jus gentium*). The last body of law became a repository of economic principles that later provided a starting point for economic analysis, especially in the Middle Ages. The Roman law of property and contract, for example, subsequently became the

[42] ibid., p. 17.
[43] Spiegel, p.35.

mainstay of legal systems of the western world. The concept of natural law, which can be traced to Aristotle, found its way into Roman law. Finally, the modern doctrine of the corporation can be traced back to Roman law. In general, Roman law provided the framework upon which the economics of a later day was slowly but surely mounted[44].

Also, ancient Rome left an important legacy in terms of the *doctrine for the regulation of economic relations.* This law led later to the idea of the *"natural law"*, which had a considerable impact on the evolution of economic thought. Of more direct significance were the doctrines that were evolved to regulate economic relations. The Romans upheld the right of private property almost without limit and guaranteed *"freedom of contract"* beyond what was appropriate to the conditions of their times. These doctrines influenced the mechanism of modern commerce to a large extent. Thus, the Roman law has served as an important basis for the legal doctrines and institution of capitalism.

[44] ibid., pp. 24-25.

III. THE RISE AND DECLINE OF SCHOLASTICISM

3.1 Introduction

The end of the ancient world marks the beginning of the *Middle Ages,* which covered nearly 1000 years. The death of the last Roman emperor in 476 AD ushered in a long period of secular decline in the west and a concomitant rise in the fortunes of the east. For five centuries, from 700 to 1200, Islam led the world in power, organisation, and extent of government; in social refinements and standards of living; in literature, scholarship, science, medicine, and philosophy. The Arab world acted as a sort of conduit to the west for Hindu wisdom and culture. It was Moslem science that preserved and developed Greek mathematics, physics, chemistry, astronomy, and medicine during the half millennium, while the west was sinking into what historians commonly call the Dark Ages. By A.D. 730 the Moslem empire reached from Spain and southern France to the borders of China and India, an empire of spectacular strength and grace. Perhaps the most significant, single innovation that the eager, inquisitive Arab scholars contributed to the west was their system of writing numbers. They displaced the clumsy Roman numerals of the previous empire with the much utilitarian Arabic numerals. Another significant contribution to the west was its reintroduction of Aristotle to the west.

The Middle Ages came to a close towards when Europe witnessed the advent of the *Reformation* and the discovery of the New World. The end of the Middle Ages also marks the beginning of *Modern Times*.

The downfall of the Roman Empire and the disintegration of its vast territorial possessions were followed by the emergence of the *feudal system* throughout Western Europe. Medieval society, where the dominant form of economic organisation is feudalism, has its essence in the class division between the *lords* and the *serfs,* which is a derivation from the structure of latter-day Rome. The growing scarcity of slaves compelled the large estates (*latifundia*) to rent out holdings apart from their own domains to free tenants or to slaves receiving a remuneration consisting of a rent in kind and/or in money and having their domains cultivated by the tenants. In addition, the establishment of *coloni* was necessitated by the need to settle the frontiers with a military population for purposes of defence. These *coloni* had special privileges but were also subject to considerable compulsion. In the 5th century the tenants were

tied to the estate by a new system of bondage that replaced ancient slavery. The decline of the Roman Empire, which permitted the delegation or placement of more administrative powers in the hands of the feudal lords, made estates the new economic units in which the *manorial system* was developed. This system inaugurated a new method of production and distribution. The wheeled plough came into use. Two yokels of four oxen each pulled it, until the oxen were replaced by draft animals and especially horses, with beneficial effects on agricultural productivity.

The *manor* was a self-sufficing economic unit[45]. Basically agricultural, the manor produced most of the articles that were consumed within it. Distribution within the manor was regulated not by purchase and sale but by the traditional rules of sharing. The manorial population or the feudal society was stratified in rigid classes, the serfs being placed at the bottom and the lords on high. The latter themselves graduated in a hierarchy of vassals, each person having a fixed status with certain rights and duties. However, there were instances where protracted struggles took place between the landlords and serfs, with the latter rebelling against the former.

While the early mediaeval times witnessed basically agricultural societies, the latter part of the Middle Ages was characterized by a less rigid class structure because of the development of trade and handicrafts, and the growth of towns. Though markets and the use of money were a much smaller entity than at present, there were traders, moneychangers and independent craftsmen with their apprentices.

With the expansion of existing towns and the emergence of new ones, however, the scope of exchange widened to a great extent. Foreign trade had given impetus to the rise of national economic policies[46]. Commerce was considerably developed giving rise to a change in the economic relations. Subsequently the *guild system*[47] was developed.

Christendom was, by this time, almost universal in Europe, and the Christian Church assumed a great spiritual and material power. Virtually,

[45] Ekelund and Hebert, p. 27.
[46] Spiegel, p.53.
[47] *Guilds* were organizations of merchants and craftsmen with their own standards of skill, prices of purchases and sales, and the rate of wages. These were also to lose their mercantile function to other organisations as specialisation became wide spread.

all scholars and writers were churchmen in those days. The writings of these scholars strove to impose moral order on the institutions of the time and particularly, aimed to regulate economic relationships[48].

In short, the two major factors that set the Middle Ages apart from Greek antiquity were its doctrinal unity provided by the Roman Catholic Church, and the pervasiveness of the market mechanism. Medieval society somewhat grudgingly nurtured nascent form of capitalism, as an economic market became more and more entrenched in the fabric of daily life.

3.2 The Rise of Scholasticism

The power and influence of the Catholic Church in the Middle Ages was due, in large part, to its autonomy in spiritual matters, but there was also another reason. The medieval clergy preserved the one light that shined during the Dark Ages - learning. The social hierarchy of medieval civilisation was almost Platonic in its structure. One belonged to the peasantry (who worked), the military (who fought), or the clergy (who contemplated). The last group alone emphasised the importance of knowledge, and so it was, almost by default, the clergy became the repository and guardians of that knowledge. Medieval economics, therefore, was the product of the clergy, particularly a group of learned writers that are now referred to as Scholastics[49].

During the early Middle Ages, Christian writers had a rather narrow vision of economic activities. Their aversion to trade and property was based on their conviction that the pursuit of wealth would drive Christians from the path of g*race*. Their approach to the study of economics was therefore purely ethical. In later medieval times, however, this intransigence of the Church found itself in strong contrast with the economic system, which rested on private property and trade; and the latter prospered with the growth of towns and the expansion of markets. The attitude of the Christian theologians had to change in order to cope with the new situation[50]. Though some of the Canonists or scholastic

[48] Ekelund and Hebert, p. 26.
[49] ibid., p. 27.
[50] The coexistence of the private property with Christian teachings was never comfortable. In the 5Th century the early Christian fathers had struck down 'communistic' Christian movements and the Church itself went on to accumulate enormous amounts of property. It was only in the 12th century that St. Francis of

writers, like the Dominican General, Raymond de Pennafort, continued to condemn trade, in the writings of the most important of them, Saint Thomas Aquinas, is found a distinct tendency to reconcile theological dogmas with the existing conditions of economic life.

Saint Thomas Aquinas was the chief exponent of Scholasticism, which dominated the thinking of his time. He resorted to Aristotle's economic[51] and ethical arguments and could not accept the idea of the unrestricted power of the proprietor sanctioned by the Roman law, which was becoming the prevailing practice. Rather he adopted the Aristotelian argument on private property. This argument, as noted above, was in favour of private property with some obligations upon the individual proprietor in the interest of the community. St. Thomas Aquinas believed that human conduct on this earth was to be judged with reference to ultimate salvation; it was the hereafter that mattered. He did not pretend that wealth was natural or good or evil, but classed it with other imperfections of man's earthly life which were inevitable but which should be made as good as their nature would permit.

From this viewpoint of property a compromise on the question of trade followed. St. Thomas Aquinas did not regard trade as natural for good; on the contrary, he agreed with Aristotle's view that it is unnatural and he added that it implied a fall from the state of *grace*. However, he held that it was an inevitable evil in an imperfect world, and could be justified only if the trader sought to maintain his family and when object of commerce was to benefit society.

St Thomas Aquinas stated that *the worth or value of a good is its just price, and if the sales price deviates from it, the buyer or the seller, as the case may be, owes restitution.*

The deviation from the just price need not be as great as is required by law, but it must be considerable. The interpretation of what constitute a just price is based on the golden rule that states: *all things whatsoever you*

Assisi began the movement of order of Franciscans, which insisted on vows of poverty, 'brotherhood' and deplored the accumulative tendencies of the Church. Against the Franciscans were arrayed the Dominicans led by St. Thomas Aquinas, who dug out of Aristotle and the Bible the necessary arguments. For further information Refer:
http://cepa.newschool.edu.het/schools/ancients.htm

[51] St. Aquinas attempted to harmonise the teachings of the Bible with Aristotle's philosophy. Haney, p. 98; Spiegel, pp. 27-28.

would that men should do to you, do you also to them[52]. In other words, since no one wishes to acquire a good at a price in excess of its worth, no one should try to sell it for more than its worth.

St. Thomas Aquinas shared Aristotle's conception that justice could be divided into *distributive justice*, applying to the distribution of the product of the household, feudal estate or other economic entity; and *compensatory justice*, applying to the exchange of goods and services. In the former, income should be that which was customary; it should be suitable to the status of the recipient. In the latter, that is, in exchange, the price of commodity should be a " just price" that is to say prices should compensate both parties fairly for the product they had to offer. In other words, the profit realized in trade was nothing other than a reward for labour. Trade, therefore, could be justified if it was designed to further the common wealth and it must ensure an equal advantage to both parties engaged in the trade. The *just wage* and the *just price*[53] were perennial ideas in the economic doctrines of scholasticism.

Saint Thomas Aquinas[54], whose objectives were to mitigate the economic anomalies of his time, relentlessly condemned the charging of interest on borrowed money or *usury.* The early church leaders had found confirmation of their opposition to usury from the Bible, and consequently they attacked both lay and clerical usury. In 325 A.D. the Council of Nicaea denied the clergy the taking of interest on loans of all kinds.[55] St. Thomas Aquinas' restatement of the doctrine of usury sharpens some of the arguments with which canonists and theologians had supported the prohibition of interest.

Later day canonists, however, introduced some refinements to the general doctrine, which made possible the sanction of the payments of interest. This was the case when money did not actually change hands but was

[52] New Testament, Mathews, 7:12.

[53] It was the School of Salamanca, [a prominent Dominican bastion] which was one of the homes of St. Thomas, that defined 'just price' as no more and no less than the naturally exchange-established price. Their analysis led them to trace a scarcity' theory of value and employed supply-and-demand with dexterity. They rejected the 'cost of production' conception of the just price, arguing that there was no objective way of determining price. Refer;
http://cepa.newschool.edu/het/schools/salamanca.htm

[54] It may be noted here that, that in economic sphere the Scholastics [13th and 14th century theologians] were concerned with: property, justice in economic exchange, money and usury.

[55] Spiegel, 1971:64

simply withheld for a period, as in the payment of rent or hire, or payments for goods bought. In such an instance, we have a case of *lucrum cessans* for missed opportunities of gain on the part of lender and *damnum emergens* in the case of risk of loss through possible non-payment and delay in repayment after the agreed time.

3.3 The Decline of Scholasticism

The economic development, which had made the merchants powerful also, brought about the destruction of institutions and habits of thought, which might have stood in the way of commercial expansion. The new social order inspired numerous lay-thinkers to write challenging *social dissertations* the source of which was *religious dogma.* The importance of the former increased while that of the latter continued to decline.

Though the social thinkers of the time did not devise the growing new order of capitalism, their writings can be considered as a *positive contribution* to its development. These writings elaborated principles and doctrines that helped considerably to clothe the rising capitalism with conviction and respectability since it was strongly opposed and attacked by the *landed aristocracy* and *churchmen* or *scholastic writers*.

The contributions of the scholastics have been enormous. It has been stated that the prehistory of economics starts in the 13th century with the scholastic pioneers in market analysis rather than with the 17th century mercantilists. And the distinctive contribution of the scholastic economics may be broken down into three elements: an emphasis on utility as the principal source of value; the notion of the 'just price" and the proposition that money capital is sterile.[56]

[56]Mark Blaug, *Economic History in Retrospect*.4th ed., Cambridge: Cambridge University Press, 1990, p.29.

IV DEVELOPMENTS IN POLITICAL THOUGHT

4.1 Introduction

The unity of thought that had been the hallmark of the Middle Ages began to vanish since the sixteenth century to be replaced by a great diversity of approaches. The multiformity of opinion reflected the growth of the various nation-states, which coloured the thinking of their citizens, the rise of a secular approach in place of the religious one[57], and the differentiation of the religious foundation itself into various branches. The movements were interrelated in turn since in many instances the nation-state was not only a territorial but also a denominational unit[58]. In the following sections we note some of the developments that took place in the political thought which have direct bearing in the development of economic thought.

The forces, which had made commerce predominant were freeing men's minds from the fetters of accepted belief, opening a new era of speculation and experiment. There were advances in almost all branches of science and the culmination of such progress is found in Newton's monumental work the *Principia*. The developments in natural science have also been reflected in the political thinkers of the period. For example, Thomas Hobbes was so entranced by Galileo's reverse vision of dynamics, which claimed that the natural state of objects was one of motion, rather than rest, that Hobbes sought to apply this idea in comprehensive social philosophy. In his work he envisioned it in three parts: in the first part he would relate the general laws of motion. In the second part he would show humans can be considered bodies in motion and how they are impacted by external motion; and in part three he would give the results of these dynamics human interactions on the body politic[59].

4.2 Niccolo Machiavelli (1469-1527)

A Florentine statesman in the service of the rulers of Florence, Machiavelli was one of the intellectual leaders of the *Renaissance* period.

[57] This reflects the development of political thought from purely canonical origin to philosophic radicalism.
[58] Spiegel, p.76.
[59] These three parts are developed in his works: of Man; of Body; and of the Citizen.

His political outlook is clearly outlined in his famous book: *The Prince*[60], where he rejected the moral codes of the clergy in politics and supported the idea of the *supremacy of the state*[61] over all other sources of power, including the Church. Basing his thesis on the concept that *the end justifies the means* he declared that the extension of its power and material prosperity were necessary objectives of the state or the Prince who, as a benevolent dictator, is the personification of the state.

What Machiavelli wrote in his book was actually happening in Italy at the time. He was able to witness that substitution of the secular for the ecclesiastic authority and the achievement of national unity. This struggle occurred in its most violent form in Italy. In his genius, he was able to make the political upheaval of his day as the starting point for a new means of approach to social and political questions. One had to be aware, he argued, of the great differences between *man as he was* and *man as he ought to be*; he maintained that to try to be virtuous in a world inhabited by so many who were without virtue was to court ruin. In his study of the actions of a wise Prince he pointed out that *necessity* and *not virtue* was to be the guide.

By separating his science of politics from morals and religion, Machaivelli set a precedent that in later times was followed by the exponents of the social sciences, including economics. However, although his influence in the political field was immense, since from then on the social philosophy was to be based on rational and positive foundations, he committed many errors. He was unable to foresee the rise of a new, non–theological, ethical discipline that was able to exercise some influence on economic thought.

4.3 Jean Bodin (1530-1596)

Jean Bodin was a 16th century jurist, *natural law*[62] philosopher and precursor of mercantilism. During the height of his political involvement

[60] Machiavelli took as a hero for the Prince the cruel and treacherous Cesare Borgia, the younger son of Pope Alexander VI, who is the murderer of his brother, of the husband of his sister, and of countless others. Spiegel, 1971:76-77.

[61] Haney had observed that the advocacy of both Machiavelli and Bodin, for a strong central government as a means of a national well-being, were in line with the trend towards mercantilism. Haney, 1949:112.

[62] In philosophy, natural law is the unchanging moral principles common to all people by virtue of their nature of human being. The existence of the natural law has been much discussed by theorists throughout the ages. Aristotle believed that there were

he composed his celebrated *Les six livres de la Republic* (1576), wherein he expounded his famous *theory of sovereignty*. The state, he argued, which by virtue of its position is above the law, has by right *supreme power* over the citizens, including the Church. Bodin advocated that the relation of man to man, instead of man to God must be the foundation of social inquiry. Consequently, he argued that the establishment of a central sovereign authority, which would be the source of all *law* and *order,* was imperative. This central authority, he contended, ought to be secular. However, while Machiavelli advocated placing absolute power in the hands of the *benevolent temporal prince*, Bodin, because of his awareness of the danger of unrestricted authority, stated that both the *divine law* and *natural law* should prescribe the broad limits of power.

Bodin's interest in economics was provoked by the writings of the time, which laid forth the standard argument that the Europe-wide inflation raging at the time was due to the debasement of currency and clipping. In his 1568 tract, he put forth what is now known as his *quantity theory of money*[63], detailing the relationship between price levels and the money supply. He is also credited with identifying the causes for the rise in prices, which he stated were: the abundance of gold and silver (this is very important and clear statement of the quantity theory of money); the practice of monopoly; scarcity caused by export; the luxury of the king and his great lords; as well as the debasement of the coin. He also advocated for free trade and that it should not face obstacles by laws and regulations.

4.4 Francis Bacon (1561-1626)

This English lawyer, courtier, philosopher and essayist is better known for laying the foundations for experimental science[64], although he made

universal and immutable laws laid down by nature, while the medieval theologian St. Thomas Aquinas regarded natural law as the part of divine law that is discoverable through human reason. According to such theories, human laws derive their validity from natural law, and if a law conflicts with moral values, it is not fit to be regarded as a law. *Oxford Paper Encyclopaedia,* Oxford University Press, 1998.

[63] Its importance in doctrinal theory is great because by implicitly involving the demand and supply apparatus it prepared the ground for the eventual emergence of the demand and supply analysis as a general explanatory principle, a development that stretched over three centuries and culminated in the work of Alfred Marshall at the close of the 19th century. Spiegel, p.86.

[64] He exalted the merits of induction and observation as opposed to the utilitarian approach of Bentham and others.

significant contributions to the political thought of his time. His political writings were of significance in the formulation of political doctrines. *Monarchy,* he thought, *was a natural institution* and obedience to it, he considered, *a natural duty*. He upheld the doctrine of the *divine right of kings* and gave *absolutism* a theoretical support. To the absolute sovereign, he argued, was assigned the role of *supreme judge*, who would not be fettered by prejudice or laws and, who would stand above the warring social factions.

He exalted the merits of the induction and observation over the utilitarian method of the Benthamites. In 1616, Bacon enunciated a mercantilist doctrine, which states *let the foundation of profitable trade be thus laid that the exportation of home commodities be more in value than the importation of foreign, so we shall be sure that the stocks of the Kingdom shall increase, for the balance of trade must be returned in money or bullion*[65].

Bacon attempted to express his political views in his book: *New Atlantis* [1626], which was published after his death. In the book he attempted to describe an ideal arrangement of a society based on hierarchy of rulers. *New Atlantis* describes a Utopian society, which contained an institution, called Salomon's House, charged with the organised study of nature. It appears that his suggestion was partially realised with the establishment of the Royal Society in Britain.

4.5 Hugo Grotius (1583-1645)[66]

Hugo Grotius was a Dutch legal scholar, playwright and poet. As a *natural law*[67] philosopher, he is generally credited as the originator of *natural morality* and the *social contract* theory of the state. He has written widely on various socially important topics and his book *Mare Liberum*[68], written in 1609, promoted the idea that seas should be free for the innocent use and mutual benefit of all[69] – an idea disputed subsequently by some mercantilists. His 1625 treatise *De Jure Belli et*

[65] Quoted in Spiegel, p. 99.
[66] http://cepa.newschool.edu/het/profiles/grotius.htm
[67] The laws of nature have been interpreted as rational principles derived from the nature of man and society. Spiegel, p. 135.
[68] Freedom of the Seas
[69] Spiegel, p. 99.

Pacis[70] is acknowledged as the first in international law. More importantly, Grotius argued that *property* was the outcome of social consent, and thus had nothing *inalienable* in it.

4.6 Thomas Hobbes (1588-1679)

This *natural law* philosopher lived during some of the most tumultuous times in European history. He lived part of his life in an England, which witnessed turbulent political strife and unrest. Thus his theories were thoroughly pessimistic regarding human nature. He believed that man was not naturally good but naturally a selfish hedonist. Thus, as human motives[71] were guided by unenlightened self-interest, these could, if left unchecked, have highly destructive consequences. He believed that, left unrestrained, humans, propelled by their internal dynamics, would crash against each other, and life in such a state of nature would be *solitary, poor*, *nasty, brutish and short.* Thus, it is no wonder that he is his averse to popular rule and support for the establishment of an institution of *absolute monarchy*. Apparently, he was continually persecuted by fear of violence from his childhood days and he wrote that *he and fear, like twins, were born together*. On the other hand, Hobbes rejected the concept of the *divine right of kings* and based his philosophy on the *egoism of human nature* and the *social contract.*

For Hobbes, egoism of human nature is at the root of social contract. As individuals take the line of least resistance and pursue their own interests, these various individual bodies form an artificial body known as the state. Since, the attainment of all-purpose is threatened by the war of every man against every man, a social contract is established whereby men accept a common power, which will protect them from themselves and from each other; keep the peace, and make possible the satisfaction of a modicum of human desires. Civilised arts and industries develop because men give up their natural liberties for the sake of an artificial and preferable state. However, Hobbes did not intend the *social contract* to be an actual historical occurrence, but rather that it would be the principle by which every one accepts to live in society. The contract engaged in by the

[70] On the Law of War and Peace

[71] There are two key components in Hobbes's conception of humankind: he was materialist, claiming that there was no more to the mind than the physical motions discovered by science, and a cynic, holding that human action was motivated entirely by selfish concerns, notably fear of death. His view of society is thus expressed in the Leviathan. Oxford Paperback Encyclopaedia, Oxford University Press, 1998.

citizens with the *Leviathan*[72] (written in 1651) allowed the state to coerce in the interest of the ruled.

Hobbes attacked the concept of the division between temporal and spiritual power, which dominated the minds of his contemporaries. The supreme power or sovereign, he argued, must be *absolute,* not bound by popular will or by popes. Hence, the Church is either the only government or it is no government at all but a servant of the sovereign. He maintained that the only *Kingdom of God is in natural law and not in the Church.*

The power of the kings, he maintained, comes because of the very nature of their *Office*. Any ruler, lawful or otherwise, was possessed with the fundamental attributes of kingship. He was radically emancipated from religious influence, a thing that made churchmen view him with suspicion. Moreover, since this belief gave theoretical support to the usurpers[73] of power, the churchmen viewed his views with suspicion.
Nonetheless, as all people are equal (*in physical and not in moral sense*), possessing a passionate love of survival (*right of nature*) and some degree of rationality (*law of nature*), Hobbes concluded that a viable, working society would arise as an equilibrium between these competing forces. Thus, it is no wonder that on the subject of taxation he supported equality of burden: ... *it concerns the duty of the magistrate to see that the public burdens be equally borne. Furthermore, since what is brought by the subjects to public use is nothing else but the price of their bought peace, …they who equally share in the peace should also pay an equal part…*[74]*.*
Moreover, in the *Leviathan,* he indicates that the test for benefit should be expenditure, and that the one who saves should not be penalised; *when the impositions are laid down upon those things that which men consume,*

[72] The Hobbesian view of man as motivated above all by individual self-interest posed basic political problem, which he maintained could only be solved by an all-powerful state. In discussing value in the Leviathan, emphasised individual estimation. He referred to the value or worth of a man as being the price and as being dependent on the need and judgement of others. See Hutchison, 1988:24; Haney, 1971:130.
[73] Generally regarded as one of the most prominent "natural law" philosophers of the 17th century, Hobbes is also considered as one of the progenitors of "legal positivism", which states that justice is whatever the law says. Hobbes maintained that law itself is completely dependent on power. A law without a credible and powerful authority behind it is just simply not a law in any meaningful sense.
See: http://cepa.newschool.edu/het/profiles/hobes.htm
[74] Quoted in Hutchison, 1988:386

every man pays equally for what he uses, nor is the commonwealth defrauded by the luxurious waste of private men[75].

4.7 Samuel von Pufendorf (1632-1694)

Samuel von Pufendorf was a German jurist, philosopher and historian known for his contributions to natural law and international law. In his main work, *De jure naturae et gentium* [76], which was influenced by Grotius and Hobbes, he argued that all men are entitled to be free and equal and that international law is not restricted to Christendom but is common to all nationalities. Furthermore, he stated that civil society was established largely on contract between individuals, but that sovereignty rests in a benevolent ruler. Here he gave philosophical rationale for State paternalism, which was then taken up by German mercantilists. He made a careful distinction between *usefulness*, a quality intrinsic in a good, and *utility*, a property of the relationship between the good and its consumer. He justified the existence of private property.[77] In his book: *Of the Power of the Christian Religion in Relation to the Life of a Citizen,* written in 1677, he advocated state superiority over the church in matters of civil affairs.

4.8 John Locke (1632-1704)

Prominent empiricist philosopher, natural law social thinker and Whig political theorist, John Locke was nonetheless a rather traditional mercantilist in his economics. His fame was pre-eminent in the period of the *Enlightenment*[78] and he is supposed to have done for human nature what Newton has done for the physical world. His famous book: *Essay Concerning Human Understanding* was published in 1690 and the pre-Revolutionary French philosophers considered it as the liberator of the human mind from the trammels of supernatural authority. According to

[75] Quoted in Haney, p. 137.
[76] Of the Law and Nature of Nations, 1672
[77] http://cepa.newschool.edu/het/profiles/pufendorf.htm
[78] Enlightenment or the "Age of Reason" is a philosophical movement that sought to replace authoritarian beliefs with rational scientific inquiry. It began in England in the 17Th century and spread to France and Germany during the 18Th century affecting every sphere of thought in Europe. As scientific knowledge increased, some scholars began to question the accepted beliefs, and criticism of established society and assumptions spread throughout Europe.

Locke, the human mind is not born with innate ideas but rather as a blank sheet, a *tabula rasa,* which acquires knowledge empirically, that is, all ideas come from experience.

His thoughts in the political field are positive contributions to the social studies. The *social contract*[79], which to Plato had men build city-states, in Hobbes submit to the *Leviathan* and in Bodin had established and set the limit to central authority, is also found in Locke's political doctrine. However, unlike his predecessors, Locke was inspired by the *voluntary association of merchants* to advocate that such association was a natural form of organisation for purposes of government. He believed that *rationalism* found political expression in *constitutional monarchy.* Freedom he argued, must be only restricted in the interest of preserving it. Thus, Locke has become the forerunner of western democracy and particularly of modern political organisations.

In the area of economics, Locke maintained that the earth belonged to all men in common, and that private property was justified in so far as a human being had mixed his own labour with the gift of nature. This discussion led him to the conclusion that labour was the main source of value. Nearly the whole value of the product of the soil was, he argued, due to labour; the rest was a natural gift.

Locke provided a penetrating analysis of the relationships between the satisfaction of wants and human happiness and the relationship between present and future wants. He pointed out that man always had the tendency to over emphasise the urgency of present wants over future once, and that everyone acts to satisfy his own wants rather for the good of the society. On the other hand, he asserted that man might not always be choosing wisely.

On the question of the value of goods, Locke enumerated that demand for a commodity depends upon a number of factors including its utility, taste of the buyers, fashion, convenience of the buyers' etc. He also brought in the idea of market demand, which was but the sum total of individual demands as expressed through their apportioning of money expenditure for that particular good.

[79] In the two Treatises of Government, published in 1690, designed to combat the theory of the divine right of kings, he finds that the origin of the civil state is in a contract. The legislative or government having fiduciary power for certain ends, there remains still in the people the supreme power to remove or alter the legislative when they find the legislative act contrary to the trust reposed on them.

Locke raised the fundamental question of the creation of value by laying his finger on labour, but he did not reach Petty's conclusion that labour is also a measure of value. Locke also discusses the theory of money. He develops his argument in terms of relative proportions of money and other goods, brings in the idea of the velocity of circulation of money and thus, provides a basis for the quantity theory of money. He says that the change in the market value of any commodity, in relation to another commodity, is not indicative of a change in its intrinsic value, but only a change in proportion of the two commodities and the same principle applies to the proportion between money and other commodities.

Locke, observed that the amount of money needed to finance a given volume of trade was hard to determine because it depends not only on the quantity of money but also on the quickness of its circulation. Thus, if the quantity of money in a country were halved while retaining the yearly product of commodities, then either the actual trading or the prices would be reduced to half. In this way he was stating that price level was directly proportional to the amount of money and the velocity of circulation, and inversely proportional to the amount of goods to be traded.

Locke related money supply to the theory of interest, also. He noted that the interest rate was dependent upon the amount of money, which was seeking employment. He also indicated the role of money in accentuating the inequalities of income and wealth. Because money was not perishable, there was no upper limit to its holding, consequently this [fact] enabled the inequalities to widen. Money could either be used for direct consumption of goods, which it could purchase, or it could be used for earning a yearly income (like the rent of land). In this context Locke echoes the mercantilist view that money was identifiable with capital.

V. DEVELOPMENTS IN POLITICAL ECONOMY

5.1 Introduction

The economic writers, which appeared during the two centuries that preceded the formulation of *Classical Economics* together with the other streams of thought, are referred to as the founders of political economy. These economists were the precursors of the classical economics, which has become dominant during the 18th century in Europe. Samplings of the leading writers of the period are given below.

5.2 Sir William Petty (1623-1687)

Petty is considered to be the founder of modern political economy. In 1662 along with his colleagues he established the *Royal Society of London for Improving of Natural Knowledge.* The programme of the Royal Society was to apply the empirical processes of observation and experiment, in the first instance to the study of the natural world and technology, and then to the study of society.[80] Throughout his life Petty remained an active member of the Royal Society.

Petty is credited as an advocate and exponent of empirical, quantitative method or of *Political Arithmetic.* In the preface of his book written in 1672, printed posthumously in 1690, he stated: *Instead of using only comparative and superlative words and intellectual arguments, I have taken course…to express myself in terms of number, weight, or measure; to use only arguments of sense, and to consider only such causes as have visible foundations in nature*[81]*.* He saw his own work in *Political Arithmetic* as an application of the empirical research programme of the Society to the human and social world[82].

His outstanding achievement was the conceptual derivation of the national income, a step that was path breaking but of small influence on the thought of his contemporaries and many subsequent generations of economists[83].

[80] Hutchison, p.28.
[81] Quoted in Spiegel, p.122.
[82] Hutchison, p. 28
[83] Spiegel, 122-135

Petty advanced a theory of value, where he attributed the sources of all wealth to labour. In fact, he regarded that all wealth was the effect of past labour and that labour was both a *source* and *measure* of value. Production, he maintained was the result of co-operative effort on the part of labour.

Petty connected value and rent by making use of the hypothesis that the true rent is the excess of land produce over the labour and material cost of production of that produce. Rent was considered a surplus and it was the only surplus, which he accepted and it contained the concept of profit. Petty also introduced the concept of differential rent because he believed that price of land and not the other way round determined rent. Petty went on to develop the theory of "par" or the value of land in terms of labour. All things ought to be valued by two natural denominators, which are land and labour. That is, we ought to say that a ship or a garment is worth such a measure of land, such a measure of labour, for as much as both ships and garments were the creatures of lands and men's labour thereupon.

In the same way, Petty considered that usury was the rent for money. The rate of interest would be determined by the rent of land. In the case of risk-free loans, he maintained that the rate of interest was equated with the rent of that much land that amount of money could purchase.

Petty was not able to make any advancement regarding international markets and his views were quite mercantilist. He opposed the exportation of bullion and the limiting of exchange and interest rates. But the use of statistical methods enabled him to see more clearly the working of the monetary system than had been the case with mercantilists. He found out that for both England and Ireland the equality of money was only a position of the total amount of annual expenditure. This led him to develop the concept of the velocity of circulation. He was therefore able to see that though money was very helpful to the economy of a country, the real salvation of an economy laid in improving its productive efficiency. Furthermore, he was able to point out that there was something like the optimum quantity of money that a country might have more or less than that amount, and that such an excess or shortage was not desirable.

Petty pointed out that the supply of money could be adjusted, but he was not able to give a specific relationship between money and prices. Moreover, in spite of his understanding of the labour theory of value, Petty was against giving more wages to workers. A worker, he said, should be

paid only to *live, labour and generate* but not more, since *if you double wages, then he works but half as much as he could, or otherwise would*[84].

Petty also studied the forms of public expenditure and the optional methods of disbursing the same. An important contribution by Petty to the theory of public finance is that *the State should never try to tax the people too much because in itself taxation has a depressing effect on the productive and other economic activities of the country*[85]. Though he expected the members of the society to pay towards the maintenance of the state, he maintained that their willingness to pay would have to be conditioned by the expenditure policy of the state and their views regarding the equitable distribution of tax burden. However, he believed that *to judge the relative taxable capacity of the taxpayers, the State needs relevant data and here comes the importance of statistics*.

In the *Treatise on Taxes and Contributions* Petty was concerned with laying down the principles of public finance. He proposed that the main headings for expenditure should be in the order: defence; law and order; government; the religious establishment; education; provision for the destitute and the unemployed; and public works. As regards the tax to be collected to offset the cost he suggested that a proportional tax be imposed. He suggested that… the tax be never so great, if it be proportional unto all, then no man suffers the loss of any riches by it. For men…if the estates were halved or doubled would in both cases remain equally rich[86].

Petty's views on population are expressed in his *Treatise of Taxes and Contributions.* He said that fewness of people is real poverty and the reasons he gives have novel features: population growth is attended by increasing returns since the overhead, the cost of government, does not rise nearly so fast. As density of the population goes up significant improvements occur on the quality of the population. To him, population growth is an ever-recurring theme, and he considered the matter as solution both to national economic problems and to his own problems as owner of huge tracts of thinly settled land.[87]

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[84] Spiegel, p. 130.
[85] Petty has been called the first English scientific writer on taxation. Haney, p. 137.
[86] Hutchison, p. 32. *As a general rule, taxes should be proportionate and neutral with respect to the prevailing distribution of wealth. This is based upon welfare considerations, which demonstrate a penetrating psychological insight*. Spiegel, p. 132.
[87] Spiegel, pp. 130-131.

Petty agreed with the contemporary view that *that there is a certain measure or proportion of money required to drive the trade of a nation*, but he goes on to say that not only smaller but also larger amount would be prejudicial to trade. In the latter case the money could be sterilised by keeping it in the king's coffers[88]. Furthermore, in his attempt to estimate the desirable money supply and he related it to the velocity of circulation.

Finally Petty, stressing on the proportionality concept laid it down that … *men should contribute to the public charge but according to the share and interest they have in the public peace; that is, according to their estates or riches*[89].

5.3 Sir Dudley North (1641-1691)

John Locke and Dudley North were immediate followers of Sir William Petty. So they show a lot of common understanding on economic theories. North had spent most of his time as a merchant, and His *Discourses Upon Trade* [published in 1691] was produced right at the end of his life, having been stimulated by the proposal to reduce the maximum interest rate by law, and also debates about coinage[90]. His *Discourses* has been widely regarded as providing the most forthright general statements forthcoming from English writers of the seventeen the century. North attacked the central doctrine of mercantilism, namely, the theory of balance of trade. He maintained that international trade, being a voluntary activity, could not be a source of loss to any party. He noted that the interests of all countries were interdependent and so he advocated for "free trade", arguing that foreign trade could not subsist without domestic trade. He believed and expressed, for the first time, the view that the whole world was as much an economic unit as was a single nation. He regarded all trades as profitable because he argued that no one would continue to trade in an unprofitable occupation.

His comments in the field of interest and money were also quite penetrating. In the abatement of interest, he felt that the government should not put a limit on interest rate. He felt that it was a universal maxim that as more buyers than sellers raises the price of a commodity, so more borrowers than lenders will raise the interest. Also, he attacked the idea that

[88] ibid., p. 131.
[89] ibid., p. 33.
[90] ibid., pp. 79-80.

it was lack of money that depressed trade. Gold and silver were exchanged like all other goods and were in no sort different from other commodities. So that an active prudent nation grows rich and the sluggish drones grow poor[91]. On the other hand, Hobbes was anticipating the Smithian and classical idea that no one wanted money for its own sake, or that hoarding was irrational, and not a serious problem.

5.4 John Law (1671-1729)

Law made an important contribution to the theory of money and provided a distinction between the *use value* and *market value* of a commodity. He maintained that use value or utility is necessary for a good to command a market value, but it does not determine the market value. The market value however depends upon the relative supply and demand position of the commodity. He gave the well-known examples of water and diamonds to prove this point. Water has a high use value but on account of its abundance it has a low market value; diamonds on the other hand have very law use value, but command a high market value in account of their scarcity.

Discussing on the theory of money, Law argued that without adequate supply of money trade could not prosper and that any other legislation to help trade would be ineffective in the face of scarcity of money. He supported the view that an abundance of money was helpful to the development of trade and commerce. Moreover, Law thought that through the issue of paper money the scarcity of money would be removed, and as the public got used to paper money, bullion would accumulate in the state treasury. He therefore drew up a plan for a note-issuing bank in Scotland in 1705[92], but unfortunately it was rejected. He was however permitted to establish one in France but the note issuing created speculation and inflation leading to disastrous results. In England the Bank of England was permitted to issue only a specified amount of notes backed by government securities and with gold backing for all notes, which exceeded this amount.

[91] ibid., p. 80.

[92] In 1705 John Law had written a pamphlet, Money and Trade Considered, with a Proposal for supplying the Nation with Money, which had considerable influence. In this pamphlet, among others, he advocated for a paper currency based on land. His thoughts, as expressed in the pamphlet, are important not so much as foreshadowing the ideas of the Physiocrats but rather as a further blow to those of the mercantilists. See: Haney, p.126; Spiegel, pp. 175-177.

Though the amount of security-based notes was inflationary in nature, he maintained that its limited amount did not lead to as much inflationary pressures as happened in France. It may, however, be recognised that the idea of note-issue on the strength of government securities laid the foundation for modern financial set-ups in which public debt plays a fundamental and crucial role. However, he warned that unless the issuing of the bank notes was controlled the results could be disastrous.

5.5 Richard Cantillon (1685-1734)[93]

Cantillon [an Irishman who made his money in France] has been named the greatest economist but his name has remained in obscurity for over a century. In his book, *Essai sur la nature de commerce en general*[94], which was written in 1730 but published posthumously in 1755, he covered a wide area[95]. The topics covered include: the introduction to political economy; the nature of wealth; the social and economic organisation of people; wages of labour; theory of value; the relative valuation of labour and land; the dependence of all classes upon the landed proprietors; the population problem; the use of gold and silver; foreign trade; foreign exchange; banking and credit.

Cantillon began his thesis with the proposition that land was the source of wealth and that the wealth was produced with the power of labour that works on land. In the theory of value, Cantillon showed the distinction between the *intrinsic value* and the *market value*. Intrinsic value of a good, he maintained, is determined by the amounts of labour and land that go into its production, although in some cases labour may account for almost all the cost of production, for example, as in watch making, while in others it would be the land, such as in woodcutting. He pointed out that the intrinsic value of the commodity might be different from its market value, and this divergence would depend upon the relative strength of demand and supply forces. Cantillon pointed out that agricultural produce (e.g. corn) would sell at a price different from its intrinsic value depending upon its supply in relation to its demand.

Cantillon had to face the difficult problem of the *par* between land and labour. The solution to the problem was sought by thinking of the labour

[93] See : Spiegel, pp. 177-183; Hutchison, pp. 163-178.
[94] This [work] may justly be called a forerunner of the science of political economy. Haney, p.174.
[95] His work had remained undiscovered until its rediscovery by Jevons in 1881.

cost of producing the labour power. Where there is certain subsistence level needed for the maintenance and reproduction of labour, the amount of land needed to produce that subsistence or its equivalent would be the land equivalent to labour. In this way, he showed that the land equivalent of labour is the intrinsic value or the cost of production of labour itself. Thus, he laid down a cost of production theory for goods in general.

Cantillon has also made contributions to the discussion on the quantity of money needed in circulation. He proposed that the quantity of money circulating in exchange fixes and determines the price of everything in a state, taking into account the rapidity or sluggishness of circulation. He did not support the advocates for paper money but rather sought for a realistic substance, which met the requirements for money.

5.6 David Hume (1711-1776)

David Hume was a Scottish philosopher whose work: *Treatise of Human Nature* (1739) had greatly influenced the general philosophy of Adam Smith. Hume was an essayist writing in philosophical spirit, but working out no complete economic system[96]. Thus, amongst his essays: *of money; of Interest; of Commerce,* and *of the Balance of Trade* are the most important.

The chief characteristics of his economic thoughts are the prominence given to labour, the attention given to changes or transitions, evidences of historical spirit, and the interrelation of economic and other social facts and forces[97]. In the field of money, he pointed out that money represented commodities, and hence the quantity of money on the one hand and quantity of goods on the other determined the value of money. However, he did not distinguish the value of money as a commodity and the value of money in terms of other commodities, especially since the velocity of circulation of money would also affect the latter. However, Hume made a valuable contribution in terms of the effects, which a change in the quantity of money would bring in the economy. He pointed out that, if along with changes in the quantity of money, habits of people also changed bringing about changes in the volume of trade and the demand for money, prices could remain unaltered. But if prices rose, as would generally be the case, there would be beneficial results for the economy. He pointed out that in the period of rising prices, wages lag behind and profits increases. This was

[96] Haney, p. 209.
[97] ibid., p. 209

considered desirable development according to Hume, because of their stimulating effect on production and employment.

As regards interest, Hume stated that a high interest rate was dependent upon three things; a high demand for loans; a relatively small supply of loans; and a high profitability of investment. If these forces work in the opposite direction, the result will be a low rate of interest. The decline in interest rate in Britain argued Hume, was as a result of increased supply of loans, and therefore a low interest rate was the result of flourishing trade in the country and not the cause of it.

5.7 Sir James Denham Steuart (1712-1780)

Steuart was the chief English mercantilist writer of the eighteenth century, and he is regarded as the last of the mercantilists. He had spent a good part of his adult life outside of Britain and especially in Germany thus some of his thinking was attuned to the German cameralists than British liberalism. His book *Principles of Political Economy* was published in 1767, and he was the first to use the term *Political Economy* in an English book. His work is divided into five books which discuss population, and agriculture; trade and industry; money and coin; credit and debts; and taxes[98].

Steuart saw a very close relationship between increases in agricultural[99] production and population growth. He maintained that population growth proceeds on the basis of an agricultural output, which exceeds the requirements of the farm population. It will be produced in response to a reciprocal demand, that of the non-agricultural population for foodstuffs and that of farmers for manufacturers. Industrial development thus becomes a prerequisite both for the expansion of production in the agricultural sector and the growth of the population facilitated by such an expansion. The factor behind industrial development is the multiplication of wants, a matter that is responsive to the manipulations of the statesman.

[98] Spiegel, p. 215.

[99] Steuart assumed a three-stage theory of economic development: the most primitive stage was that of nomads, or savages, living off the fruit and meat supplied by nature. The second stage was that of agriculture, with the regular application of labour to land, which made possible a great increase in food supply and population. The agricultural surplus had a vital role. For with the third stage there was a surplus of food which could be used to meet other basic, subsistence needs, so that manufactures could develop; and with the greater variety of goods, and the expansion of trade there came the emergence of money and an exchange economy. See: Hutchison, pp. 339-341.

Steuart discussed the welfare of the citizens of a country as being the responsibility of the state. He repeatedly emphasised the objective of high level of employment:

> *A statesman should make its endeavour to employ as many of every class as possible, and when employment fails in the common run of affairs, to contrive new outlets for young people of every denomination … Such members of society as remain unemployed, either from natural infirmities or misfortunes, and who thereby become a load upon others, are really a load upon the state … A state should provide retreats of all sorts, for the different conditions of her decayed inhabitants: humanity, good policy, and [religion], require it.*

Furthermore, Steuart insisted on the need for keeping the *balance of work and demand*. He insisted that the greatest care must be taken, to support a perfect balance between the hands in work and the demand for their labour. The balance was important to Steuart not with a view to enrich the state, but in order to preserve every member of it in health and vigour. Lack of balance would result in any of the four inconveniences: either the industrious starve one another; or a part of their work provided lies upon hand; or their profits rise and consolidate; or a part of the demand is not answered by them.

Steuart made notable contributions to the theory of price and demand. He distinguished two elements of price, the *real value of the commodity* and *the profit upon alienation.* The real value of a good is determined by the worker's subsistence and expense during average working time required for the completion of the good[100] and by the value of material, which reflects again working time and subsistence. The market price could be above it and the profit so yielded would depend upon the conditions of supply and demand. This approach enabled Steuart to develop the demand and supply theory of value and at the same time maintain the mercantilist idea that a surplus could arise not only through productive activity but through sales transactions also.

Steuart explained how the distribution of wealth is affected by change in people's assets and how these changes in turn are facilitated by the introduction of *symbolic money*, that is bank notes, credit in bank, bills, bonds and merchants books. The circulation of money serves the

[100] This foreshadows Marx's concept of socially necessary labour time.

acquisition of goods, services, or claims; among the goods, some are consumable while others are not[101].

[101] Spiegel, 1971:218-220

VI COMMERCIAL CAPITALISM AND ITS THEORY

6.1 Introduction

The unity of thought that has pervaded the Middle Ages began to vanish in the sixteenth century to be replaced by greater diversity of approach. Some of the important forces that swept away the medieval world are:

- The growth of the *national states* which were anxious to destroy both: the *particularism* of feudal society and the *universalism* of the spiritual power of the church, which resulted in a greater concern for wealth and a quickening of economic activities;

- The loosening of the central doctrinal authority by the *reformation* and the progress of the concept of *natural law* in jurisprudence and political thought which prepared the ground for a rational and scientific approach to social problems;

- The invention of printing, which through mass printing brought low-cost books within the reach of the masses created new possibilities of intellectual communication;

- The revolution in the method of farming which dictated the adoption of production for market purposes, instead of subsistence crops, the consequences of which were: rural overpopulation; the growing commutation of feudal dues; and the increased indebtedness of feudal lords, which forced them to resort to trade or to adopt new methods of farming for the market;

-Maritime discoveries, which gave rise to a very great expansion of foreign trade. The search for new and shorter routes to reach Asiatic markets led navigators, such as Vasco Da Gama and his colleagues, to circumnavigate the African continent. Christopher Columbus who, adopting the then new theory expounded by Copernicus that the Earth had a global shape started his navigation westwards with a view to reach India and made the greatest maritime discovery of all times, the New World. The discovery of the American Continent certainly gave a formidable impulse to the foreign trade of Western Europe; and
- The *renaissance,* essentially a re-birth movement in arts and literature, and which covered the period extending from the 15^{th} century to the close of the 17^{th} century, gave a salutary impulse to the development of

intellectualism thus contributing, though indirectly, to the decline and downfall of feudal thinking.

The foregoing factors not only assisted in sweeping away the feudal system but also helped to revolutionise commerce. The commercial revolution that took place was accompanied by changing in the organisation of production. A new phase appeared in which the *merchant capitalist* dominated the productive process, which was carried out by small craftsmen. The merchants' profit was the process of monopoly and extortion. During this phase the merchants' position was dominant, though this phase inevitably developed towards a primitive form of industrial capitalism; the *verlag* (putting out) system in which the merchant manufacturers employed semi-independent craftsmen working in their homes. This practice inaugurated the so-called *town economy* which was the forerunner of the *factory system* and, therefore, of *industrialism* as we know it today. This new merchant class was mostly recruited from the *merchant-capitalist* or the *craftsmen* and its interest was opposed to those *pure* commercial capitalists who had a monopoly of trade, especially of foreign trade. The rising *nation states,* which were also holders of a number of trade monopolies, strongly supported commercial capitalists and their monopolistic practices. Commercial companies, such as the *Merchant Adventurers*, the *Eastland Company*, the *Muscovy Company* and, the most important of all, the *East India Company* in England and similar trade companies in other Western European countries afford good examples of the state-supported trade monopoly-holding companies.

In order to mitigate eventual trade hazards, Western European nations, such as England, France, Holland, Spain, Portugal etc., embarked upon colonial ventures, making colonisation an important and efficacious weapon. Thus, the world witnessed the colonisation of the *Americas* and some trading centres in Asia. The colonised territories, of course, gave strong impulse to the trade of the colonising powers.

The social position of the commercial capitalists was considerably raised through their intermingling and association with the *landed aristocracy* by means of intermarriage and through the political powers bestowed upon them by the growing *national states*. The acquired new social prestige, added to their economic power, made the commercial capitalists a highly dominant class.

The rise of the *nation* states brought about consolidation and strengthening of the power of the central government followed by and a corresponding loss of power to the feudal authorities in localities and regions. This laid a foundation for the successful pursuit of national economic policies and for the growth of nationalistic feelings, the strength of which was eventually to rival of the old religious ties[102].

6.2 Bullionism and Mercantilism

Mercantilism was a school of thought that dominated the western economic philosophy of the 16th and 17th century of Europe[103], and it characterised the transition from the pre-industrial civilisation to the Industrial Revolution. The term mercantilist is used to denote the philosophy of various economic thinkers such as Thomas Mun and Colbert who propounded ideas of restrictive commercial system with the object of enhancing the economic prosperity of a nation. In fact, Adam Smith introduced the term *mercantilism* in economic philosophy while criticising the restrictive commercial system advocated by the earlier philosophers.

Mercantilists can broadly be divided into bullionists[104] and mercantilists[105]. Those thinkers who attached to the regulation to the

[102] Spiegel, 1971:74

[103] "Mercantilism is the name given to some 250 years of economic literature and between 1500 and 1750. Although mercantilist literature was produced in all the developing economies of Western Europe, the most significant contributions were made by the English and the French. Landreth and Colander, p.37.

[104] The bullionist controversy had come up again in the 18Th century regarding whether or not paper notes should be made convertible to gold on demand, and it metamorphosised in the 1840s into the banking-Currency debate over the gold parity of the bank of England notes. This will be reviewed at a later chapter of this Readings.

[105] For three hundred years or more the economic thought of the Germany and Austria was largely embedded in that body of learning known as kameralism. Kammer initially denoted the royal treasure room and the 'kameralists' were essentially entrusted with filling the chamber or treasury of the prince. Such wealth designated as the wealth of the state. At the outset, kameralism was a combination of ideas: political, juristic, technical and economic. The economic thought of the kameralists are found in the writings of economists such as Johann Joachim Belchers, Political Discourse, (1667); von Horingk, Rules for making a nation Self-Sufficient (1684). Bhatia , p. 22; Haney, 1949: 150-154.

regulation of foreign exchange were known as *bullionists* by the other mercantilists. Proponents of the bullionist school did not understand the theory of international trade and so they viewed any outflow of precious metals with disfavour. Consequently, they proposed the prohibition of the export of species that allowed the outflow of gold and silver and the prohibition of imports, especially of luxurious commodities, which entailed payments in precious metals. They had the example of Spain, which had spread the precious metals it got from the New World all over Europe. On the other hand, they fervently advocated for the exportation of goods, especially manufactured goods, which would earn their country species. The mercantilists believed that there was a need to encourage the exchange of goods with a stress on the favourable balance of trade for their country. The most important representative of the bullionist school was Gerard de Malynes.

6.3 Mercantilist Writers

The contents of mercantilist ideology can be meaningfully understood and appreciated more in the context of the objectives for which it stood[106]. In general mercantilism is identified with state power, national unity, or simply the wealth of a nation. In the following paragraphs, some ideas from leading mercantilist writers are briefly presented.

Gerard de Malynes (c. 1586-1641)

Gerard Malynes, a bullionist, admitted the need for domestic and international trade, but he argued that because merchants were motivated by self-interest, the state should interfere to regulate trade in such a way as to secure the *general welfare*.

[106] In1620 the English economy was suffering from a serious crisis. A heavy fall in exports had been followed by an outflow of money and precious metals, and a severe economic depression ensued. There was a notable and virtually unprecedented outburst of public controversy regarding causes and remedies, the first significant, modern occasion when a problem of current economic policy had produced a debate of tracts and pamphlets. The three major protagonists were Gerard de Malynes, Edward Misseldon and Thomas Mun. All three agreed that the outflow of gold and silver, with the consequent contraction of the money supply, was the prime cause or substance of the crisis…. However, there was sharp disagreement as to how and why this imbalance had come about and as to the remedies that should be sought. See Terence Hutchison, p. 21.

He maintained that a country should have *a certain equality* of its exports and imports. It should not suffer an overbalancing of foreign commodities with home commodities, which will cause it to lose wealth. Such a loss may be incurred in three ways: by exporting bullion or coin, by selling domestic goods cheaply, or by buying foreign goods at too high a price *wherein chiefly consists the aforementioned overbalancing*[107].

In spite of the fact that, like money, bills of exchange were created to serve as *medium of exchange* and *common measure* in international transactions, self-seeking financiers corrupted this function. Further, he pointed out that the growth of illegitimate exchanges had destroyed the *true parity* of foreign exchanges at *par pro pari* (i.e., the ratio of the values of two currencies, which correspond to their bullion content). The disparity in the ratio of exchange, he contended, caused the illegal outflow of the treasure of the realm. He proposed that exchanges must be permitted, if necessary, only when it is on *par pro pari,* basis. All exchanges above or below it were to be prohibited. To this end, exchanges should be confined to the permission of the *royal exchanger* or some other authority authorised by the king. Doing so, he argued, would preserve the treasures of the realm.

Thomas Mun (1571-1641)

This British economist emphasised on *surplus of trade* and not on the restriction of exportation of species. He took a very pragmatic view that the wealth of a country consists of those things, which are needed for a civilised life. Such a view is in contrast with what other mercantilists took when they confused wealth with money. Mun suggested that England engage in three-cornered trade: purchase goods from one country and sell it to another one at profit. Basically he outlined twelve steps to augment the riches of a country and to increase its treasure in his pamphlet, which was written in the middle or late twenties[108]. These are:

i) The use of wastelands for the production of those agricultural products which were being imported;
ii) A reduction in consumption which would reduce the necessity of imports and increase the exportable surplus;

[107] Spiegel, p. 102.
[108] Bhatia, pp.27-28.
Mun's book is titled: England's Treasure by Forraign Trade, or The Balance of Forraign Trade is the Rule of Our Treasure. The book was written in 1630s although it was printed posthumously in 1664.

iii) A proper assessment of foreign markets, the supply of the demanded goods and then charging those prices which, keeping the elasticity of demand in mind, would ensure maximum exports;
iv) Since foreign trade involves shipping services, England should insist that the exports be transported in her own ships;
v) Export should be processed goods and not of raw materials. This would ensure additional value of the exports and greater employment at home;
vi) As far as possible, England should try to exploit her natural resources. e.g. instead of importing fish, Britain should catch their own from the sea;
vii) Entre-pot trade should be encouraged: an intermediary centre of trade and transhipment [storehouse for deposit, commercial centre for import and export];
viii) Trade with distant lands should be considered more profitable than trade with nearer lands;
ix) Export treasure should not be permitted except in trade;
x) Export duties on goods made out of the imported raw materials should be removed so as to gain over the foreigners in competition;
xi) Even on domestic goods high customs duties should be done away with;
xii) England should try to be self sufficient, as far as possible.

In the same vein, an Austrian lawyer, Philipp Wilhelm von Hornick, also wrote a nine-point manifesto in his book titled: *Austria Above All If She Only Will* [109], which was published in 1684.

[109] His principal rules of national economy, as outlined in Ekelund and Hebert, p 33, are:

1. That every inch of a country's soil be utilised for agriculture, mining or manufacturing;
2. That all raw materials found in a country be used in domestic manufacture, since finished goods have higher value than raw materials;
3. That a large working population be encouraged;
4. That all export of gold and silver be discouraged a much as possible
5. That the imports of foreign goods be discouraged as much as possible;
6. That where certain imports are indispensable they be obtained at first hand, in exchange for other domestic goods instead of gold and silver;
7. That as much as possible, imports be confined to raw materials that can be finished at home;
8. That opportunities be constantly be sought for selling a country's surplus manufactures to foreigners, as far as necessary, for gold and silver;

Antonio Serra (c. 15..-16..)[110]

Serra, a Calabrian scholar, is probably the first mercantilist writer who gave a systematic version of mercantilist doctrine in his book [*Brief treatise on the causes which can make gold and silver abundant, where there are no mines, with application to the kingdom of Naples*] written in 1613. Serra while discussing the causes, which can bring about abundance of gold and silver, maintained that these precious metals were very important and helpful for both trade and the people. According to Sierra there were two sources for acquiring these metals: either a country should have its own mines or there should be other factors, which enable a country to acquire these metals. In the latter case, he lists six determinants of a country's ability to produce an export balance. *These are: its capacity to produce a surplus of agricultural products over and above domestic consumption; its locational advantage, the volume of its manufacturing production; the quality of its population; the extent of its carrying trade, and the regulation of trade by the government*[111].

Serra maintained that industry was superior to agriculture because the products of the former could be readily sold for profit to acquire gold and silver. He maintained this argument by explaining that the final products of agriculture do not depend on the labour of the peasant only but also on weather, rain, sun as well as other conditions, which are beyond the control of man[112].

Edward Misselden (c.1608-1654)

Misselden was a leading English businessman[113] with a chequered career, who was obsessed by the idea that England needed more specie. He

9. That no importation be allowed if such gods are sufficiently and suitably supplied at home.

[110] Nothing is known of Serra [not even the dates of birth and death!], except that he wrote the treatise while he was serving time in a Neapolitan prison, perhaps in the hope of regaining freedom thereby, for it is dedicated to the Spanish Viceroy. Schumpeter, *History of Economic Analysis,* London: Allen and Unwin, 1981, p.194; Hutchison, p. 19.

[111] Quoted in Spiegel, p. 694.

[112] ibid., p.694.

[113] That so many businessmen attained stature as economic thinkers had its effects on the quality of economic thought. By the standards of their own time as well as by our own these men were well educated, trained in the humanities, familiar with several

introduced the phrase *trade balance* in his tract *The Circle of Commerce* written in 1623 to show the difference of weight in the commerce of one kingdom with another in the relationship between imports and exports. He advocated for the adoption of a policy that encouraged exports and discouraged imports, especially luxury goods. He also suggested that fisheries in England should be developed so as to make the nation less dependent on foreign supplies for food.

Also, he attempted to explain the concept of 'free trade', in his book *Free Trade or the Means to Make Trade Flourish,* which was published in 1622. However, by 'free trade', he by no means wants to endorse what the term connotes now, that is absence of restrictions on imports. Rather, he meant 'freedom from competition' and freedom to export, which is a trade that was neither disorganised nor monopolised by a joint stock Company.[114]

Jean Baptiste Colbert (1619-1683)

Many writers defended mercantilism in France, but the greatest exponent of this doctrine was the statesman, J. B. Colbert. The policy that he advocated aimed to serve primarily the power and glory of the state [or the king] by increasing its wealth rather than to increase private wealth. Thus his aim was the enhancement of the state's wealth and power compared to the rival states of Spain, England and the Dutch, with whom they were at war.

The son of a wool merchant, Colbert entered his country's public service in his youth and was chosen to manage the Estate of Cardinal Mazarin. The success with which he administered the estate caused the cardinal to recommend him to King Louis XIV, who in turn appointed him as his Minister of Finance.

Colbert fostered manufacture and commerce by tariffs on imports, bounties to French shipping, extension of French colonies and improvement of home transportation. Since plentiful and cheap labour supply was essential for these purposes, French workers were forbidden to leave the country and immigrants were attracted. He granted monopolies to encourage new enterprises, especially in overseas trade and promoted the establishment of modern industries. Under him,

languages…and able to draw on suitable authorities for quotations to support their arguments. For example, Josiah Child, Spiegel, p. 96.

[114] Spiegel, pp. 104-105.

sciences and learning were greatly encouraged through the establishment of academies, libraries and the grant of subsidies. Within a decade he doubled the King's revenues and made France the most powerful kingdom of Europe with a mighty naval establishment. The policies that he followed were later known as *Colbertism*.

Sir Josiah Child (1630-1699)

Child favoured a surplus of trade and supported an export of specie if it could result in a greater eventual inflow of it. Like Mun, he insisted that a nation should direct its attention to the general rather than particular trade balance. His main contribution however was in terms of the relationships between the rate of interest and flourishing trade and commerce. He believed that a low rate of interest encouraged expansion of trade and therefore he strongly advocated for it.

Child developed a theory of colonial economy and linked it to argument about employment at home. Colonialism implied emigration from the home country which in itself was bad, but Josiah Child found out that in some cases this emigration might also create additional demand abroad for imports from the home country, in which case home workers could be deployed more beneficially. Thus, he maintained the usefulness or otherwise of colonialism depended upon the nature of individual colonies.

In his *Brief Observations,* a pamphlet of eighteen pages and published in 1668, Child proceeded to give fifteen reasons for the economic success of the Dutch[115], which included, *their parsimonious and thrifty living; the education of their children; their employment of the poor; religious toleration, which attracted industrious immigrants, notably the Jews; and finally the lowness of interest of money in Holland.* The last was the *causa causans* of all the other causes of the riches of that people; and that if interest of money were to be reduced to the level rendered by the Dutch it would make the English equally rich….[116]

[115] Child, an outstanding figure in the economic discussion, was the wealthiest businessman of the seventeenth century. Spiegel, p. 95.
[116] Quoted in Hutchinson, p. 58.

Charles Davenant[117] (1656-1714)

Davenant, who made his career in politics and government, was also an economic pamphleteer. He was a copious and influential writer and his writings were devoted to the political and economic issues of his time. His work is of relevance because it served to illustrate that at least in England mercantilist thought was often at variance with mercantilist policy and the two must be identified.[118]

In all his writings Davenant underlines the value of the mercantilist trade policy as a source of political power. In his *Essay on the East India Trade (1697),* he took a notably free-trade stance. He argued that the trade with India greatly benefited England and he opposed prohibition of Indian goods in order to help local industries in England. In *An Essay on Ways and Means of Supplying the War,* published in 1695, he points out that the export of surplus is indispensable in financing a protracted war and that the same trade enables England to be a great sea power[119].

He proclaimed the existence of law in the economic and political world, overriding any law of government, and based, ultimately, on the self-interest of the individual. Also, he maintained that in a politically free society competitive market forces would dominate, though in a state of tyranny, where the legislative and executive authorities are not in different hands, governmental power forces may prevail.

In monetary matters Davenant was enough of a mercantilist not to play down the role of money in human affairs. He argued that money generally has to be acceptable without necessarily possessing value from the metallic, or any other physical properties, it contained. However, he warned against drastic governmental measures, such as a major reform of the currency involving debasement or depreciation.

In the first of his *Discourses on the Public Revenues (1698),* he explained and defended political arithmetic, which he defined as *the art of reasoning by figures, upon things relating to government. He maintained that the abilities of any minister have always consisted chiefly in this computing faculty; nor can the affairs of war or peace be well managed without reasoning by figures upon things*. In this and other writings Davenant showed himself a skilled specialist in the field of public

[117] Hutchison, pp. 48-53.
[118] Spiegel, 1971:137-143
[119] ibid., p. 138.

finance, a field to which he showed much of his work as government administrator. As a practitioner of political arithmetic, his definition of the national income concepts is remarkably clear and has stood the test of time. He defined national accounts as … *the whole that arises in any country, from land and its products, from foreign trade and domestic business, as arts manufactures, etc.*[120]

On the question of population, Davenant asserted that more was advantageous. He contended that population growth was beneficial because the greater density of population would provide an incentive *to invention, frugality and industry*, whereas in countries that are sparsely populated there is nothing but sloth and poverty. In fact he went further as to encourage immigration by calling upon England should open her arms *to receive all the afflicted and oppressed part of mankind.*[121] He was confident that with population growth the value of all land and rents would certainly rise.

6.4 Evaluation of Mercantilism

The study of mercantilism by historians of economic theory demonstrates that from about 1660 to 1776 the quantity and quality of economic analysis increased. The improvement in the quality of economic analysis during the later part of the mercantilistic era was so pronounced that the period has been characterised as a transitional time containing the origins of scientific economics[122].

The economic reasoning of the mercantilists may be summed up as follows:

- Mercantilists never supposed that the rate of interest was self-adjusting at the appropriate level. On the contrary, they believed that an unduly high rate of interest was the main obstacle to the growth of wealth and they were even aware of the influence of liquidity preference and quantity of money on the rate of interest. They tried to diminish the liquidity preference and to increase the stock of money in order to bring down the rate of interest. Some of them even made it clear that their pre occupation with increasing the stock of money was with a view to diminishing the rate of interest.

- Cheapness and excessive competition indicated that the terms of trade might turn against a country.

[120] ibid., p.141.
[121] ibid., p.139.
[122] Landreth and Colander, 1975:41.

- The mercantilists were first to point out that the scarcity of money could be a cause of unemployment. The policy of increasing the quantity of money "killed two birds with one stone." They argued that while 'surplus goods' gave rise to under-employment, increased stock of money, lowered the rate of interest and stimulated investment, and hence increased employment;

- Essentially the mercantilists aimed at unifying money, foreign trade and colonialism on a national scale. The advantages claimed by them were purely national. France and England became separate entities not only geographically but also economically. The views of the mercantilists have been held responsible for promoting commercial wars of the century.

- The mercantilists idea of a benevolent paternal government to safe guard the interests of the nation and subject the individual to the overwhelming national interest is quite akin to the modern concept of state socialism, which seeks to cure all economic maladies by a strong and unified national state.

- The mercantilists were the first to have a general view of society. They followed the general trend of modern opinion replacing religious and moral considerations of the medieval thought. They were the first to give a strictly non- theocratic view of social life, and they were the first to separate economic thought from theology and politics.

It may be generally stated that mercantilists paved the way for their successors and the fragments eventually bore fruit, chiefly through the criticism they brought forth. Physiocracy came as an intellectual challenge to the restrictionist and oppressive policy of the French government. Thus, its strength and weakness were derived from the nature of this reaction against mercantilism.

Initially mercantilism was not a scientific system of thought but it has benefited the countries that adopted it at the time. Some benefits were realised through the application of mercantilist policies[123]. Soon the aim of accumulating treasure in the form of gold and silver was justified because

[123] Although the mercantilists as one agreed on the necessity of international controls, they differed on where domestic controls were concerned. For example, John Hales in his tract written in 1549 and entitled: A Discourse on the Common Wealth of this Realm of England, exhibited an early and prophetic distrust on the effectiveness of legislative controls in promoting society's welfare. See Ekelund and Hebert, p. 39.

trade over long distances was rapidly replacing the household and manorial economy supplemented by barter. The money economy, which replaced the barter economy and the extensive use of money expanded trade and exchange. The accumulation of large quantities of money that took place promoted the emergence of stock companies. These undertook large commercial enterprises, which stimulated the growth of manufacture and trade. The growth of *nation-states* provided security against the conflicts of warring principalities or nobles and the ensuing peace secured the framework for wider internal markets. Modern private enterprises could scarcely have taken root without positive encouragement and aid from the state, nor could development of science be achieved without the aid, intervention or encouragement of the state. Colonisation, which is now not only discredited but also condemned, was then the only way of opening, populating and developing the American Continent. No private enterprise could or would have financed the exploration and settlement of these lands, and the contact between the West and East was made possible through mercantilism.

On the other hand, there were side effects. As the Mercantilist State was engaged in the export of manufactured goods, the export of similar commodities from rival countries constituted strong competition, as a result wages were kept low. As a consequence, workers were forced to live at subsistence level. Not only did they receive subsistence wages but they were also exploited. The duration for the workday was very long, usually exceeding twelve hours and their working environment was unhealthy and they had no proper treatment or protection whatsoever. Thus workers under mercantilism suffered greatly and their general conditions were pitiable.

Furthermore, the agricultural sector of the economy under mercantilism was placed on a secondary level, that is, it was put second to industry. In order to keep low prices so as to enable the badly paid manufacturing labourers to buy foodstuffs cheaply and to obtain cheap agricultural raw materials for the industries, farmers were not protected from the invasion of imported foreign agricultural products. On the other hand, manufacturing industries were protected by the imposition of high protective tariffs on imports, thus causing manufactured goods to sell at high prices in the local markets. Agricultural landlords and labourers had to buy manufactured goods at high prices. The fact that farmers sold their products at low prices and paid high prices for their requirements of industrial goods forced them to have a low standard of living. The export of their products was prevented by high export tariffs, or their exports, were entirely forbidden in many countries (e.g. in Colbert's France). Moreover, the “colonies” were

exploited for the benefit of the colonising countries and not vice versa, as was stipulated at the time. In the Spanish possessions, the aboriginal Indian populations were enslaved and forced to hard labour in minefields with an aim to extract and export precious metals as much as possible. Negro slaves were first introduced in the West Indies and this spread to South and North America. All in all, raw materials and mine products benefited the colonising countries.

VII - THE ECONOMICS OF THE PHYSIOCRATS

7.1 Introduction

Under mercantilism the policy prescriptions suited the interests of both the *state* and commercial capitalism. However, as commercial capitalism shifted towards industrial capitalism, the latter found its independence on the state protection decreasing. While earlier it was theorized that the *state* was to collect tax revenue corresponding to the paying capacity of the subjects, now the theoretical reasoning was *that the best state was the one that governed the least.* As England was leading in most of these economic changes most of the writings of the time reflected the transition from mercantilism to free trade and laissez faire, which are the principles embodied in the classical school.

The nature of French mercantilism however differed from the one practiced in England at least on two counts. Internal regulations were enforced much more effectively in France than in England, and from the time of Colbert onwards, grants of monopoly power were used by the crown as a more efficient means of rent seeking than taxation[124]. The French monarchs shared the power to tax with the aristocrats over the entire mercantile period, putting the tax farmer at risk without jeopardising the income of the aristocracy. Hence, the reaction to the mercantilist doctrine in France, of necessity had to take a different reaction.

The eighteenth century thus brought to prominence two schools of thought: the physiocratic and the classical one. While the physiocrats were predominantly French the classics were Scottish and English. The physiocrats had an important influence on Adam Smith, the founder of the classical school.

In France some thinkers had began to criticise the mercantilist ideology because it did not favour agriculture. The government's support of manufacture, its relative neglect of agriculture, and its inability to resolve the fiscal problem provided the background for the writings of Pierre le Pesant de Boisguilbert (1646-1714)[125]. This member of the judicial nobility and a landowner published a number of books, which basically

[124] Ekelund and Hebert, pp. 61-62.
[125] Spiegel, pp. 171-173.

claimed that agriculture and rural life are in many ways superior to manufacture and that manufacture should not be promoted at the expense of the rural population. He made a vigorous plea for higher prices for farm products and he identified the national income with consumption expenditure - thus he emphasised the role of consumption as a motor force for the economy. In connection with fiscal reform, he proposed a royal tithe that would be in the nature of a single tax, thus anticipating one of the central ideas in the physiocratic thought.[126]

Pierre Samuel Du Pont de Numours, one of the historians of the School, is credited with inventing the term *physiocracy* and it means *the rule of nature*. The underlying philosophy was the medieval concept of the *natural law*, but it also emphasised on individual rights and the justification for private property based on those rights[127]. The Physiocratic School flourished during the second half of the eighteenth century, not long before the French Revolution.

7.2 Francois Quesnay (1694-1774)

Francois Quesnay, a French physician had spent his early childhood on the farm. He studied medicine and he made a name for himself as an outstanding physician and an author of books on medicine, biology and philosophy. As he became famous, he was appointed to the Court and became first physician to Madame de Pompadour, the king's mistress, and later to king Louis XV, himself. With his profound erudition and intellectual eminence he attracted prominent men of his time to the Court, where he promulgated his ideas about economic affairs. Quesnay came to economics in his sixties[128], and it was a passing phase of his intellectual career; as after a few years his interest in economics lapsed and towards the end of his life he turned to mathematical investigations.

The principal contribution of the Physiocratic School to modern economic thinking comprised the rejection of the mercantilist concept of wealth through exchange and recognition of production as a source of wealth; the invention of the term and policy of *laissez faire, laissez passer,* which was consistent with the concept of natural order; and the *tableau economique*.

[126] ibid., p. 174.
[127] Ekelund and Hebert, pp. 72-73.
[128] http://cepa.newschool.edu/het/profiles/quesnay.htm

Source of Wealth

The mercantilists had maintained that the source of wealth lies in foreign trade and that it consisted of accumulating precious metals. The *physiocrats* differed from the mercantilists on both these counts. The physiocrats maintained that there were two types of labour: the productive and the sterile. The former consist of land, which is capable of producing a surplus, producing more than it consumed.

The *physiocrats* maintained that a product was not the creation of utility, but rather it was surplus making. The realisation of the surplus, *net product,* meant primarily a material surplus, and that the origin of all wealth lay in agriculture, which consisted of real produce. It thus followed that industry and trade were sterile or unproductive as no surplus was produced. The physiocrats arrived at this conclusion because 'production' was understood in terms of *physical increase in existing goods*. The husbandman was therefore the only producer while the landowners, who directed the extraction of wealth from the land, comprised the proprietary class.

The *physiocrats* obviously were not paying enough attention to the phenomenon of market valuation or the utility content of the various production items. The Physiocrats in their search for the source of wealth found a source, which could be seen easily and in physical terms. Definitely, the output from agriculture was more than the corresponding inputs of seeds and the subsistence needs of the peasants.

The individualism of the physiocrats was complimented by a profound respect for the sanctity of private property. The physiocrats referred to a man's property as a measure of the freedom that he enjoyed. The protection of the property rights was to them the foremost function of the *positive order*.

As for the technical economics the physiocrats employed a system of equilibrium in which the interaction of the farmers, landowners and artisans produce the national income. The central idea of this system is the exclusive productivity of the farmer. By applying his labour to land he generates a surplus, or *net revenue*, in excess of his cost of production. This surplus has two unique characteristics: it continually springs up fresh as a gift of nature that accrues to the farmer directly; and the surplus produced by the farmer serves to maintain the rest of society. That is the mixed or disposable class of landlords, the kings and the Church; and the

sterile or stipendary class comprising of artisans, manufacturers and traders[129].

Quesnay illustrated the relationship between the three classes in the famous *tableau economique*[130], written in 1758, which is an early model of the circular flow of national income. This was later supplemented by *Economie Generale et Politique de l'Agriculture,* in 1763. These two works set down the basic propositions of Quesnay's economic theory and policy.

Laissez Faire, Laissez-Passer

The physiocrats believed that the cause for social dissatisfaction was the departure from the *natural order* and they advocated that everything, which represented such a divergence, should be corrected. They believed that happiness of mankind was ordained by *nature* and that it is not alterable by any amount of human effort. They said that it was so comprehensive and all pervasive and transparent that everyone should see it. The *natural order* was a super natural endowed with all the grandeur of universality and immutability, hence no interference was recommended.

As far as the physiocrats are concerned, the striving of the *state* to produce export surplus through the device of *favourable balance of trade* has caused misery rather than welfare to society. In reality, the state's practice of favouring industry by bestowing special privileges deprived real producers of their wealth.

The physiocrats believed that man ought to be free to act on his own interest. The state should neither help nor hinder the person. They believed that the natural order comprised the institutions of private property, landed classes, peasants and an absolute although enlightened monarchy. The benevolent but absolute monarch would have only some limited functions to perform. He would maintain internal law and order, provide defence against foreign aggression, arrange for public education and provide and maintain infrastructure overheads like roads, bridges and other public works.

As for the substance of the natural order of society, the physiocrats visualised it as regulated by the principles of individualism. Ann Robert

[129] Spiegel, pp.182-186.
[130] A modified sample of the tableau is shown below.

Jacques Turgot (1727-81), a leading economist of 18th century France, had insisted that the individual is the best judge of his own interest, and to Quesnay the secret of well-ordered society was that everyone works for others in the belief that he is working for himself. The physiocrats thus postulated a perfect harmony of individual interests as well as the interests of the king and his subjects. It was in connection with the thought of the physiocrats that the phrase *laissez fair, laissez passer* was coined, a maxim that to this day has served as an affirmation of economic individualism.

The Circulation of Wealth

The *physiocrats* were the first to attempt and analyse, in a systematic way, the circulation of wealth in an economy. The physiocrats argued that the best way to trace out full effects of the oppressive royal politics in France was to conceive the mutual interaction process in any one year as a circular flow of income and expenditure. Any policy that had the effect of enlarging the *circular flow*[131] was therefore consistent with economic growth, whereas any that restricted it was inconsistent with economic growth[132].

Thus, Francois Quesnay developed the concept that the economic activity follows a kind of circular flow. His *tableau economique* shows that the people of the society produce, then consume some and save some, then produce again. It was the first ever attempt at a comprehensive description of the whole economy in which interdependence of different sectors was clearly demonstrated. The interdependence of different sectors provided the foundation for the input-output tables of the modern planners and analysis.

The *tableau economique* envisaged three classes in the economy: a productive class consisting of farmers and agricultural labourers; the proprietary class made up of landlords; and the sterile class formed by merchants and artisans. This can be demonstrated by taking two goods: grain and crafts. In this case the protagonists in the production process are five. The farmer produces grain, owns livestock and seed, hires labour, and pays rent to the landlord. The artisan produces crafts, uses local grains and foreign gods as raw materials. The labourer works for the farmer and

[131] The circular flow gives insights into the policy prescriptions of the physiocrats, who sought policies to encourage the accumulation of capital in France, which was retarded by an excessive tax burden on farmers. It has been shown earlier that the king was sharing the collection of tax with his aristocracy and the consequence was heavy tax on the producer: the farmer.

[132] Ekelund and Hebert, pp. 72-73.

receives salary for his work. The merchant sells foreign goods that he has imported and buts local grain for export. Finally, the landlord owns land, and receives rent from the farmer.

Quesnay used the term *avance* to denote capital, that is, expenditures during a production process that are drawn from previously accumulated fund. He identified four types of capital depending on the sort of expenditures they were earmarked for. These were:

> *avances foncieres* [fundamental advance] one time capital expenditure during the production process undertaken by landlords on their land; such as land clearing, drainage, fence building, etc.;
> *avances souveraines* [sovereign advance] one-time capital expenditure undertaken by the government, e.g. roads, bridges, etc.;
> *avances primitives / avances originelle* [primitive advance] expenditure on durable producers' goods, e.g. horses, cattle, ploughs, etc.; and
> *avances annuelles* [annual advances]expenditures on the wages of labour and non-durable producers' goods, e.g. cattle-feed, seed, etc.

The two last types of capital, *avances primitives* and *avances annuelles,* are very important as both of them require previously accumulated capital. On the basis of these interactions, Quesnay came out with a flow chart that involved the participation of all the protagonists. In the final analysis, he shows that despite the interaction of all participants, it is only land that has shown the surplus value that has been created with the assistance of the farmer.

According to the physiocrats, since only the productive class creates all wealth, some of this wealth is kept for its maintenance while the rest is circulated in the economy to return to the productive class. However, amongst the shortcomings of the theory are the exclusiveness of productivity given to agriculture and in that it does not provide for the eventualities like the failure of crops or the failure of the landowners in providing the annual advances.

Two of the major contributions of the physiocrats are prominently displayed in the *tableau*: the circular flow of income and the idea that capital is a series of advances. The advances theory of capital became one of the most fervently held concepts of the classical economists, as exemplified in their theory of the wages fund. A simplified *tableau* is shown below:

The Physiocratic Input-output Table

		Input (purchases)			
		Farmers	Landlords	Artisans	Total
Output (sales)	Farmers	2,000	1,000	2,000	5,000
	Landlords	2,000	0	0	2,000
	Artisans	1,000	1,000	0	2,000
	Total	5,000	2,000	2,000	9,000

All quantities are given in livres. [Adapted from Staley, p. 36.]

The Table illustrates the circular flow of income, but of all it reveals the interdependent character of the sectors of the economy, by the amounts purchased by each sector from others entered as a total rather than having to be calculated as a sum of transactions.

7.3 Theory of Price

The contributions of Quesnay are not limited to the *tableau economique*. Among others, he also contributed to the arguments on value theory. Quesnay's *bon prix* forms part of his value theory, which although not fully developed has a number of interesting features. The *bon prix* stands in a certain relationship to the *prix fondamental,* which is equal to the cost of production. Market prices firm a spectrum. On the one end they may fall short of the cost of production, in which case they will cause losses. On the other end, they are 'excessively high' and constitute a 'burden'. The *bon prix* is located between these extremes. It is a price that yields a gain and thus constitutes an increase to maintain or expand production. The *prix fondamental* forms a link between Quesnay's price theory and his theory of value. He distinguishes between value in use [reflecting individual needs] and value in exchange, the latter being referred to as *valuer venal* or *sales value.*

7.4 Ann Robert Jacques Turgot (1727-81)[133]

Turgot was a busy administrator with wide-ranging interest in history, literature, philosophy, natural sciences and economics. His important but rather short work is *Reflections on the Formation and Distribution of Wealth*, first published in 1770. In this work he made it clear that the network of detailed mercantilist regulation of industry was not simply intellectual error, but a veritable system or coerced cartelisation and special privilege conferred by the State. He maintained that freedom of domestic and foreign trade followed equally from the enormous mutual benefits of free exchange.

In proceeding to a more detailed analysis of the market process, Turgot pointed out that self-interest is the prime mover of the process, and that individual interest in the free market must always coincide with the general interest. He said that in line with the principles of *laissez faire*, the government would not be expected to oversee every operation in a market, as it would also be unnecessary and too expensive. He pointed out that on a free market, there will always be a cheating merchant and a duped consumer, but then the cheated customer will learn and cease to frequent the cheating merchant, who will fall into discredit and thus will be punished for his fraudulence.

As a minister of Finance under Louis XVI, Turgot was able to introduce six edicts some of which did not work out well. In the fifth edict he dissolved the guild system, which had since the Middle Ages kept stultifying hold over commerce and industry, and by the sixth edict he eliminated the *corvee,* which was a yearly labour owed by peasants to the state and implemented the Physiocrats' favourite policy of *l'impot unique* (the single tax on property).

One of the remarkable contributions of Turgot is his paper on *Value and Money* written around 1769. In this paper he developed where at first there is a Crusoe type economy, followed by a Crusoe and a Friday type of economy, and later on a four-person economy. Using these different scenarios, he was able to develop economic laws that transcend exchange and apply to all individual actions.

[133] Although often lumped together with Quesnay and the Physiocrats, his contributions to economic theory were quite distinct and advanced considerably physiocratic theories.

Turgot's theory of production followed the physiocrats – only agriculture is productive, so there should be a single tax on the land. But the main thrust of his theory was quite different from that of the physiocrats. He readily conceded that natural resources must be transformed by human labour, and that human labour must enter into each stage of the production process. Thus, the basis classes of factors of production are land, labour and time.

Also, one of Turgot's contributions to economics was his brilliant and almost off-handed development of the laws of diminishing returns. He was able to pint out that increasing the quantity of factors raises the marginal productivity until a maximum is reached, after which the marginal productivity falls, eventually to zero, and then becomes negative.

The roster of Turgot's outstanding contributions to economic theory, the most remarkable was his theory of capital and interest, which in contrast to such fields as utility, sprang up virtually full-blown unrelated to preceding contributions. Not only that, but Turgot worked out almost completely the Austrian theory of capital and interest a century before it was set forth in definitive form by Eugen von Bohm-Bawerk[134]. Turgot pointed out that wealth is accumulated by means of consumed and saved annual produce. Furthermore, he said that the capitalist-entrepreneur must first accumulate saved capital in order to advance their payment to labourers while the product is being worked on. In agriculture, the capitalist-entrepreneur must save funds to pay workers, but cattle, pay for building and equipment, etc., until the harvest is reaped and sold and he can recoup his advances. And, so it is in ever field of production.

In connection with the theory of money, Turgot was emphatic against the idea that money was purely a conventional token, he declared that… *it [money] is not at all by virtue of a convention that money is exchanged for all the other values; it is an object of commerce, a form of wealth, because it has value, and because of the value of exchanges in trade for equal value*[135].

[134] See Murray, Biography of A.R.J.Turgot. [Online http://www.mises.org/turgot.asp]
[135] A.R.J.Turgot, Reflections on the Formation and Distribution of Riches. New York: Augustus M. Kelly, 1921. [Online from Liberty Fund].

In his unfinished dictionary article or essay *Values and Monies*[136], written in 1769, he declared that all valuations of money are subjective and relative. They have nothing fixed and change from one moment to the other, following the variations in human desires. He thought the measures were not perfect as the real moneys were not made from the same type of metal but from either gold or silver, whose values tend to change.

[136] Turgot may be considered a forerunner of the marginalist revolution as this work contains strikingly well developed demand-based theory of price. Refer to Online: http://cepa.newschool.edu/het/profiles/turgot.htm

VIII. CLASSICAL ECONOMICS: 1776 - 1848

8.1 Introduction

Classical economics is the system of economic theory expounded in the writings of mainly British economists between Adam Smith whose *Inquiry into the Nature and Causes of the wealth of Nations* was published in 1776 and John Stuart Mill whose *Principles of Political Economy* was published in 1848. The principal contributors to classical economic theory were Adam Smith, Jean-Baptiste Say, David Ricardo, Thomas Robert Malthus and John Stuart Mill.

What the classics proposed forms a sharp contrast with earlier trends of thought in economics. The medievalists had been inclined to rely on charity as a means of resolving the economic problem. The mercantilists had exalted the pursuit of national gain and had seen in it the clue to power and plenty. The physiocrats in turn had made the most of agricultural reconstruction as a device to beat scarcity and poverty. With all these proposed solutions the classics found fault[137]. The laissez faire principle, competition, and the labour theory of value are outstanding features of the teachings of the classical school of economics.

It is true that the economic ideas of the scholastics, physiocrats, and mercantilists contained the seeds of concepts that were eventually articulated into a more or less unified system by the classical economists. A number of characteristics link these individuals and distinguish them from previous and subsequent economic writers. Their most significant departure from mercantilist thought was their favourable attitude towards the results that flow from the natural working of economic forces. The classical vision of a mostly harmonious economic system contrasts sharply with the mercantilist and scholastic beliefs that the market is characterised by disharmonies calling for restraints or intervention. This sanguine vision of the operation of markets, with its various aspects and ramifications, is one of the chief traits of classical thought[138].

The physiocrats of France first significantly advanced the view that markets automatically provide harmonious solutions to the conflicts flowing from relative scarcity. Assuming such harmony, it followed that

[137] Spiegel, p. 241.
[138] Landreth and Colander, 1pp. 61-63.

the government should adopt a general policy of non-interference in the economy - a policy of laissez faire. Whereas the scholastics considered it appropriate for the church to adjudicate the morality of economic activities and the mercantilists advocated government intervention, the classical school, like the physiocrats, favoured free, unregulated markets and maximum individual freedom. They were sure that freedom and liberty were good in and of themselves. But freedom, particularly economic freedom, also provided a means by which the economy could function most efficiently. Individuals and businesses, they averred, should be free to trade without government interference. The classics, moreover, perceived political and economic freedom to be inseparably bound; the two cross-fertilised each other[139].

Although the primary vision of the classical economists was one of a harmonious working-out of the economic process, they were very much aware of conflicts in society, particularly between the landlords and those advocating and benefiting from economic growth change. The long-run tendencies of capitalism as seen by both Adam Smith and David Ricardo led to such dissonant results that economics came to be called the dismal science. Thus, the seeds of both modern orthodox and heterodox visions can be seen in the classical economists[140].

Since the development and full flowing of classical thinking between the 18th and 19th century, two broad developments relating to the concept of harmony in the economic system may be traced. On the one hand, although continuing to accept the basic premise of harmoniously operating economic system, it has slowly but steadily weakened its stance by increasingly advocating political rather than market responses to economic problems. On the other hand, some heterodox economic ideas have denied the harmony accepted by classical economics and find in the system such fundamental conflicts that resolution would require major changes in the institutional structure[141].

A second characteristic of the classical school is its concern for economic growth. Being essentially macro-oriented, the classical economists sought to discover the forces that determine the rate of economic growth, however, these economists had a much broader frame of reference than modern macroeconomists. They were concerned not only with the

[139] ibid., p. 61
[140] ibid., p.62
[141] ibid., p.62

economic forces that determined growth but also with cultural, political, sociological and historical factors[142].

Their concern for growth led the classical economists to a study of markets, and the price system as an allocation of resources. The classical economists studied the formation of relative prices and markets in order to understand their impact on economic growth. The classical economists were very much interested in the forces changing the distribution of income over time and, therefore, in the causes of changes in relative prices over time[143].

Final unifying characteristics of classical economics represent another notable departure from mercantilist thinking. Even though the mercantilists' theoretical structure was weak, they trusted their ability to understand the operation of the economy. This view of the mercantilists contrasts sharply with the scepticism of Adam Smith, who questioned the wisdom [let alone the expertise] of politicians who dared substitute their judgement for those of the market[144].

8.2 Adam Smith (1723-1790)

Background

Adam Smith is regarded as the father of economics because above all he was a system builder[145]. He was born in 1723 in Scotland, the only son of a father who had died a few months before he was born and a mother who lived to a ripe age of ninety. He was educated, first at Glasgow for three years and later, at Oxford University where he studied for six years. He became a Professor first of logic and then of moral philosophy at Glasgow. In Paris he met with a number of French philosophers including Francois Quesnay, the founder of the school of physiocracy. Smith had opportunity to attend some of the *conferences* held by the latter.

Smith's philosophical views are embodied in his treatise: *The Theories for Moral Sentiments*, first published in 1759. The treatise and its problems attracted immediate interest and fame for its author. In the

[142] ibid., p.63.
[143] ibid., p.63.
[144] ibid., p.64.
[145] Ekelund and Hebert, p. 100.

treatise he expounded his philosophical concepts, mainly based on his faith in the *natural order* imparted to him by his teacher, Francis Hutcheson[146].

According to Smith, human conduct was actuated naturally by six motives: *self-love; sympathy; the desire to be free; a sense of propriety; a habit of labour, and the propensity to truck, barter and exchange one thing for another.* With these motives as the basis of human behaviour, each man becomes the best judge of his own interests and, therefore, should be left free to pursue them in his own way. If left free to pursue his own advantage, man not only promotes his own interests but also cause the *common good.* The different motives of men are so balanced by *providence (the natural order*) so that no conflict of interests could result. Man's *self-love,* for instance, is checked by his *sympathy,* which leads him to promote the advantage of others. *The natural balance* of motives is most effectively at work in economic affairs. It was his belief in *the natural balance of human motives,* which inspired Adam Smith to formulate his celebrated statement that in pursuing his own advantage each individual was "*led by an invisible hand to promote an end which was no part of his intention".* Adam Smith believed that in this way the individual promoted the interests *of society* more effectively than if he set out to do so. He emphatically stated that he has *never known much good done by those who affected to trade for the public good*[147].
Smith's system combined a theory of human nature and a theory of history with a peculiar form of natural theology and some hardheaded observation of economic life. *The Wealth of Nations*[148] is made up of five "books", which discuss production and distribution with special reference to labour, capital, economic development, the history of economics, and public finance. The first two books stand out as the most important on

[146] Francis Hutcheson [1694-1746] had trained a whole generation of students including Adam Smith in the Whig philosophy of personal liberty and government restraint, and progressive views on social justice, representative government, colonial autonomy, and the rejection of slavery. Also, in his famous book: Systems of Moral Philosophy (1755) he holds that man has innate moral sense, so that he is born knowing what is good and right, hence his famous phrase 'the greatest happiness of the greatest number' as a criterion for action. See: Haney, 1949: 208; Oxford Companion to English Literature, Margaret Drabble and Oxford University Press, 1995; The Macmillan Encyclopaedia 200,. Market House Books Ltd., 2000.
[147] Bhatia, pp. 75-76.
[148] According to Landreth and Colander [1983:84], narrowing to the economic sphere, the three main features of Smith's central analysis are the division of labour, the analysis of price and allocation, and the nature of economic growth. His conceptual history of civilisation identified four evolutionary stages.

such matters as division of labour[149], and the theories of value, price, wages, profits, and interest. These are briefly treated in the following sections.

Division of Labour

Smith sees that the per capita national income is determined by two factors: the productivity of labour and the proportion in which productive labour stands to non-productive labour. While the productivity of labour is related to the division of labour, the non-productive labour he interpreted to include those engaged in the services. The latter is line with the thinking of the physiocratic School!

Smith ascribed the favourable benefits derived from division of labour to three[150] circumstances: the resulting increase in the workman's skill and dexterity; the saving of time which otherwise would be lost in passing from one species to work to another; and the invention of machinery which facilitates and abridges labour. The last advantage results from the narrow focus of the individual's attention on a particular object occasioned by the division of labour[151]. Unlike Plato's *Republic*, the division of labour in Smith's *The Wealth of Nations* is not derived from any indigenous inequality of men. Thus it calls for economic mobility and freedom of entry into occupations closed to no one because of alleged inherent disabilities. For Smith, the division of labour is limited by the extent of the market[152]. Hence, only by widening the market can the full benefits of division of labour could be realised.

The distinction of labour into productive and unproductive has been contentious. Smith maintained that those who fall under the unproductive category are maintained by the income of others, and they fail to reproduce their income, whereas productive labour adds to the value of the subject upon which it is bestowed. Those who upheld the distinction included Malthus, Mills and Marx. On the other hand, Say, Lauderdale, McCulloh and Senior seriously questioned it. The difference of opinion

[149] In Adam Smiths view, self-interest, the development of property rights and the division of labour were intertwined in the historical process of economic growth. In his conceptualisation of history he identified four stages. These were: hunting, pastoral, farming and commercial era. Ekelund and Hebert: pp. 103-104.
[150] Ekelund and Hebert, p.120.
[151] ibid., p. 112.
[152] Spiegel, p.246

has served as a foundation of most disparate trends of thought[153]. In the form given to it by Marx, the distinction became a precept of socialist economics and as such still controls the conceptual derivation and measurement of the national income of the Soviet Union and its satellites.

Theory of Value

The fundamental role that Adam Smith assigned to markets led him to speculate on how markets operate and to analyse the nature of value. The natural value of anything, he thought, was measured by the labour, which is involved in making it. No body, he reasoned, would take the trouble to make anything unless he thought it worthwhile. If he could buy something he wanted at less cost than the labour of making it himself, he would buy it, giving in-exchange something that the other participant in the transactions could buy (in terms of labour) at less cost than he could make it. A man is rich or poor, Smith argued, according to the amount of useful things, which he can obtain. When division of labour has taken place his own labour can provide him with only a few things, and his wealth will come to depend on the amount of the labour of other people, which he can command. *The value in exchange of any commodity, which he possesses, will then be equal to the amount of labour* it can command. He concluded that *labour is the real measure of the exchangeable value of all commodities.* This gave rise to the mutual gain concept from specialisation and trade. *The natural value* of anything depended not merely on the *amount of time* required to make it, but also on the *intensity of the labour*, the *training or education* that underlay the *skill of the worker, and like factors*[154].

Use value and Exchange Values[155] **-** Smith distinguishes two uses of the word *value*. One is the *value in use* (use value), which signifies the utility of some particular object and, the other, *value in exchange* (exchange value), the power possessed by the object purchasing other goods. As this point, he mentions his *famous paradox* which runs as follows: *"some of the most useful commodities such as water, have scarcely any value in exchange, while others such as diamond, although of little use, can command a great deal of other commodities in exchange."* It was this

[153] ibid., p. 247
[154] ibid., p. 248.
[155] In this distinction Smith is in accord with the idea of valeur usuelle and valeur vinale as held by Quesnay and the Physiocrats. See Haney, p. 217.

paradox that led economists of the later nineteenth century to theorise about and formulate the *marginal utility* doctrine.

Surplus Value - Adam Smith distinguishes two kinds of revenue which derives from the value of the product: one which is used for the subsistence of the worker, the other is the deduction from the value produced by the worker which goes in favour of either the landlord or the owner or the stock, or both. He thus recognised that part of the value of labour (surplus value) was apportioned to the capitalist in the form of *profit.*

Value in Money Economy - So far the discussion of value has referred to the barter economy. In an economy, however, which uses money[156], the market price of commodities, i.e. *nominal* value was not, Smith argued, always equal to the *real value* because of the *mechanism of demand and supply*. The effective demand for any article, that is, not just the desire for it, but the demand plus the desire backed up by willingness and ability to pay for it sometimes exceeded the supply. This would increase the price, which goes as *added gain* to the producer. Such a situation however does not last long, for the high profit attracts new suppliers who are willing to supply more of the article in question. The increase in supply reduces the price, perhaps below the *real value.* Real value, or *an approximation to it,* appears when, after fluctuations, demand and supply at any price is balanced. Thus, Smith maintained, that the *natural price* is *the central price to which prices of all commodities are continually gravitating*[157].

Wage Theory

In the *Wealth of Nations* are found various definitions of wage theory ever developed[158]. However, in general his doctrine is that wages depend on labour supply and demand[159]. The *wage-fund theory or doctrine* refers to the amount of wages that are advanced to workers in anticipation of the

[156] Smith was aware about the shortcomings of monetary measures, which tended to vary over time. Thus the pains he took to distinguish between the real and nominal prices.
[157] See For example, Spiegel, pp.248-250; Haney, pp. 222-223.
[158] Smith offered a number of theories to explain wages: subsistence theory of wages; a productivity theory; a bargaining theory; a residual claimant theory; and wages fund theory. Landreth and Colander, p. 91.
[159] Haney, p. 223.

sale of their output[160]. Wages could not be increased unless the capital destined to pay them was increased. Capital, in turn, was determined by saving. The doctrine pre-supposes that there is a fixed fund or capital destined to pay wages. Because production process is time-consuming, it requires previously produced goods that labourers can use for food, clothing, housing, and other things between the start of the process and the final sale. The wage fund and number of workers determine the average wage or wage rate. In the long run, the supply of labour was related to the minimum of subsistence needed to sustain the labour force. If the wage rate rose above this, the population increased; if it fell below, the labour supply contracted. Thus, in the long run, the level of the demand for labour was determined by the size of the wage-fund, which in turn will be determined by the level of savings. It follows that any increase in wage rate would result in increased labour supply so that wages will eventually fall back to the former level, thus anticipating the Malthusian theory of population[161].

Distribution Theory

The personal distribution of income depends on the prices and quantities of factors of production sold by individuals. To Smith, the *money proceeds of the productive process* were distributed as *wages, profits and rents*. Labour is the only factor of production owned by most households, so a household's income generally depends upon the wage rate and the number of hours worked. The amount of property income received by those households that do own property depends on the quality of capital and land held by the household and the prices of these factors[162].

Wages – Aside from the question of aggregate level of wages, Smith extended the discussion of *equilibrium wage differences,* by which is meant the wage premiums occasioned by certain conditions of employment. Whereas the aggregate level of wages is an important macroeconomic variable, the notion of equilibrium wage differences is one of microeconomic consideration. Workers similarly trained and similarly situated in every other respect will nevertheless earn more or less according to the degree of time and expense in acquiring skills, the

[160] The doctrine maintains that workers are dependent upon capitalists to provide them with tools to work with and with food, clothing, and shelter in order to survive. Ekelund and Hebert, p. 114.
[161] Landreth and Colander, p. 91.
[162] ibid., pp. 90-91.

degree of risk and danger in employment, and the extent of trust required by employers[163].

Smith offered a number of theories to explain wages. He suggested a subsistence theory of wages, a productivity theory, a bargaining theory, a residual theory, and a wages-fund theory. Apparently, he was not disturbed by the contradictions among these positions. In other parts of his Book I, he explicitly rejected some of his own propositions. However, two aspects of his discussion of wages deserve further comment. These are the disadvantage of labour in the wage-bargaining process, and the denial by government for employees to combine while allowing the employers to form associations to combat employees demand[164].

Wages, however, are not as high as they might be because of the *competition of workers* for jobs. The lower limit of wages, Smith thought, was a minimum of subsistence, since beneath this level, labourers would die, Adam Smith observed correctly that scarcity of labour in countries, such as the north American colonies, where a rapid increase of the national wealth took place, led to high wages. Wages, therefore, like other prices, were subject to the *law of demand and supply.*

In the *Wealth of Nations*, Smith elaborated these issues and broadened the discussion of *the inequalities of wages and profits arising from the nature of employments* themselves. Briefly, wages vary in inverse proportion to the agreeableness of employment [the most detestable job holder is to be paid better]; wages vary in direct proportion to the cost of learning the business [education in ingenious and tedious professions must be paid higher]; wages vary in inverse proportion to the constancy of employment [the higher wages to less permanent jobs]; wages vary in direct proportion to the trust that must be placed in the employee; and wages vary in inverse proportion to the probability of success[165].

Profit – Smith's discussion of profits per se is unsatisfactory by contemporary standards for the simple reason that he offered less of a theory of profit determination than he had insights into the profit making process[166]. Smith appears to have accepted the legitimacy of profits as payment to the capitalist for performing a socially useful function,

[163] Ekelund and Hebert, p. 115
[164] Landreth and Colander, p. 91.
[165] Ekelund and Hebert, p.116.
[166] ibid., p.116.

namely, to provide labour with the necessities of life and with materials and machinery with which to work during the time-consuming production process. Smith did not explain why the profits and rent had to be deducted from the output of labour. He had defined profit as revenue derived from stock [capital] by the person who manages or employs it. He conception of profit emerges as the sum of two payments: a return on capital advanced, and a compensation for bearing risk.[167] Furthermore, he declared … *the lowest ordinary rate of profit must always be something more than sufficient to compensate the occasional losses to which lending, even with tolerable prudence, is exposed. Were it not more, charity or friendship could be the only motives for lending*[168]. On the other hand, in the measurement of aggregate profits he suggested that interest be viewed as a proxy for profit.

Furthermore, he maintained that the rate of profit tended to decrease when a nation accumulated capital, since more capital meant more competition in industry. Extremes of wealth and property, he noted, were more marked in backward societies.

Rent – Smith suggested at least four theories of rent, all of which contradict one another. The origins of rent are variously held to be demands of landlord; monopoly; differential advantage and the bounty of nature[169]. Rent[170], Smith argued, was in essence a *monopoly price.* The quantity of good or desirable land is limited and those who own it can extract something from the consumer, which is a payment neither for labour nor for necessary capital. In his analysis of rent, however, he foreshadowed the influential doctrine of unearned increment. Early on the *Wealth of Nations* Smith regarded rent as price determining, whereas later Smith anticipated Ricardo and regarded rent as price-determined[171].

[167] ibid., p. 117.
[168] Adam Smith, The Wealth of Nations, p.96 quoted in Ekelund and Hebert, p. 117.
[169] Landreth and Colander, p. 92.
[170] Smith's discussion of rent hinges on three factors: monopoly elements; the residual surplus, and alternative costs. The rent of the land is naturally a monopoly price. It is not at all proportioned to what the landlord may have laid out upon the improvement of land, or to what he can afford to take; but to what the farmer can afford to give. Ekelund and Hebert, p.118..
[171] '… high or low wages and profit, are the cause of high or low price; high or low rent is the effect of it' quoted in Blaug, *Economic Theory,* p.49.

Trade

Smith considered domestic trade to be more productive than foreign trade, since the capital employed in domestic trade will generally encourage and support a greater quantity of productive labour at home and raise the domestic national income more than would an equal investment in foreign trade. Nevertheless, he maintained that foreign trade has an important function to fulfil because it opens up a market for goods produced in excess of domestic requirements and provides opportunities for the employment of capital accumulated in excess of the needs of the home economy. Once economic conditions favour exports these will be made, and they do not need special encouragement by public policies. Regulations that subvert this order reduce the material income below what it would be under free trade[172].

Taxation

The best known of Smith's contributions to public finance is his enumeration of the four canons of taxation. Taxes he maintained must be equal, certain, convenient and economical[173]. The upshot of this theory of incidence is that all taxes fall ultimately on landlords because of their ownership of a fixed immobile resource. He mentions the 'ingenious theory' of the physiocrats without approving of *l'impot unique,* nevertheless leans in the direction of favouring the taxation of ground rent[174].

Role of Government

The physiocrats had extolled a natural order based on natural law as opposed to positive law. Natural law implied a restriction on the functions of the government, in the interests of liberty of the individual. This belief thus led to believe that the government could rarely be more effective than when it was minimal. Its' intervention in human affairs caused more harm than good. The less the government interfered in human affairs, Smith argued, the better it was. If each individual member of the community were left free to seek to maximise his own advantage, he

[172] Spiegel, p. 253.
[173] ibid., p. 254.
[174] Blaug, *Economic Theory*, p. 59.

would be compelled by the natural law, and would contribute to the maximisation of the *common good***.** The *natural order,* Smith stated, allows only three *proper* functions[175] for governments: *defence from external aggression*; *establishing and maintaining an exact administration of justice;* and the *maintenance of those public works and institutions that cannot be undertaken by an individual or group of individuals for lack of adequate profit.* Thus, peace at home and abroad, justice, education and maintenance of public enterprises, such as roads, bridge, canals and harbours, are all the activities through which the state can promote public welfare. Beyond these, the *invisible hand* is more effective.

Evaluation

Smith's attack of the mercantilist doctrine, which emphasised the state regulation of trade, particularly foreign trade, was merciless. If competition, freedom of trade, and specialisation were desirable within a nation, Smith argued, they must be equally desirable among nations. No nation can gain by making something, which it could buy more cheaply elsewhere. Yet states resorted to tariffs and subsidies, which, he held, did but effects that extravagance. Without tariffs and subsidies, he contended, each nation would naturally specialise in the types of production in which they were best qualified. In any case, the production of a nation constitutes its wealth and the more of value it can produce with the labour available, the richer it will be. Monopolies affecting international trade are just as undesirable as those operating at home.

Smith also held that whereas *consumption is the sole end and purpose of all production*[176]*,* mercantilism sacrificed the interest of consumer to that of the producer. This statement is considered to be Smith's central attack on mercantilism.

Though Smith had many ideas in common with the Physiocrats, he criticised their doctrines, which held that agriculture was the sole source of wealth. Smith believed that agriculture was of prime importance in an economy, but he also regarded Industry and commerce as being equally productive.

[175] Ekelund and Hebert, p. 122.
[176] This has also been described as Smith's Law in the same vein as one mentions Say's Law of Markets.

8.3 Thomas Robert Malthus (1766-1834)

Introduction

Thomas Robert Malthus was a son of an English country gentleman, Daniel Malthus and he was born in 1766 in Rockery, England. He studied philosophy, mathematics and theology at Cambridge, and he took holy orders in 1797 and held a small curacy for a short period. He married in 1805 and shortly he was appointed a Professor of modern history and political economy at the East India Company's College at Haileybury, the first appointment of its kind in England. He died in 1834, the year he saw the abolition of the old Poor Law and the passage of a new Poor Law that may have been inspired by his writings.

Besides his *Essay on Population* and his *Principles of Political Economy*, he published a number of minor but significant publications on strictly economic questions, such as *An Inquiry into the Nature and Progress of Rent* (1815), *The Measure of Value Stated and Illustrated* (1823) and *Definitions in Political Economy* (1827)[177]. He married at 39, had three children but no grandchildren[178].

Population Theory

Malthus is an important, although controversial figure in classical economic thought. He has been described as the most famous social scientist of the nineteenth century. That fame rested on what was in effect a long pamphlet, *An Essay on the Principle of Population, As It Affects the Future Improvement of Society; With Remarks on the speculations of Mr. Godwin and M. Condorcet, and Other Writers* (1798)[179].

Malthus was not the first writer to make the obvious point that the growth of population is ultimately limited by the food supply. He was, however,

[177] Blaug, *great Economists,* pp. 141-144.
[178] Ricardo, who married at 21, had eight children and 25 grandchildren.

[179] The 50,000 words *Essay* was eventually converted into 250,000 words. The *Essay* went through subsequent editions in 1803, 1806, 1807, 1817, and in 1826. Finally it culminated in *A Summary View of the Principles of Population,* published in 1830. Despite numerous modifications through its several editions, however, the essential principle of the first *Essay* remains unchanged. Ekelund and Hebert. P. 133.

the first to bring it home to readers with the aid of simple, powerful metaphor. Population, when allowed to increase without limit, increases in *geometrical* ratio, while the food supply can at best increase in *arithmetical* ratio; so, whatever the plausible rate of increase of the food supply, an unchecked multiplication of human beings must quickly lead to standing-room only. The contrast that he drew between the two kinds of mathematical progressions carried the hypnotic persuasive power of an advertising slogan. It was easy to see that even the smallest finite sum growing at the smallest compound rate must eventually overwhelm even the largest possible finite sum growing at the highest simple rate.[180]

Three factors appear to account for the formulation of Essay on Population: the first and second factors constituted the historical setting of his theory while the third factor reflected his intellectual setting: The first was the pressure of population on England's food supply. Until about 1790 England was self-sufficient in its food supply, but beginning in that year it became necessary to import food and prices rose noticeably. However, to make matters worse, Napoleon had placed an embargo on British ports following the war and foreign grain was effectively kept out of England. Hence, British farmers were forced to increase production of domestic grain in order to feed the population. As a result, land rents increased, so much that landlords felt they had a vested interest in continuing to keep grain imports out of England. The *Corn Law* passed by Parliament in 1815 effectively prohibited importation of foreign grains to England's shores[181]. Moreover, the landlords demanded that the existing price floors on imported grain be raised, thereby increasing the rental value of their lands. The business interest, on the other hand, spoke of against higher tariffs on grain and argued for the total repeal of the Corn Law.

A second factor was the perceived increasing poverty of the lower income classes. England was becoming urbanized as factory production replaced production in the home, and with the growth of the towns the misery of the lower-income class appeared to increase. Unemployment and poverty already were problems creating calls for remedial treatment. The latest version of the "poor laws" liberalized previous law by providing that the poor should have a minimum income irrespective of their earning. The law linked family income to the price of bread, and if earnings fell below the prescribed level, allowances would be granted to make up for the

[180] Blaug, *Great Economists*, p. 141.
[181] Haney, p.125.

difference. This system, which prevailed in the rural parishes and in some of the manufacturing districts, quite naturally sparked, heated debate[182].

The third factor was an argument that developed between Robert Malthus and his father. Daniel Malthus subscribed to the optimistic belief of the perfectibility of people and society. This faith in progress was based in part on the works of William Godwin (1756-1836)[183] and the Marquis de Condorcet (1743-1794). In a sense these thinkers were the key influences on the younger Malthus in that he purposely set about to demolish their theories.

According to Godwin, the human race is perfectible through continuous advance toward higher rationality and increased wellbeing. Since a person's character depends on the social environment instead of being immutable and determined by heredity, a perfect society will produce perfect people. The major obstacle to progress, Godwin said, is private property, economic and political inequality, and the coercive state[184]. Population growth, he believed, would not be a problem. When the population limit is reached, humanity will refuse to propagate itself further.

The Marquis de Condorcet was a sceptic in religion, a democrat in politics, a physiocrat in economics, and a pacifist. In his book *Sketch of the Intellectual Progress of Mankind,* he pointed out that social progress is based on three fundamental principles: equality among nations; equality of individuals within nations, and the perfectibility of humanity. Ultimately the equality of nations, he wrote, would abolish war *as the greatest of plagues and as the greatest of crimes*. The equality of individuals would be won when differences in wealth, inheritance, and education were eliminated. Condorcet favoured the wide distribution of property, social security, and universally free education for women and men. He believed that natural order tends towards economic equality, but that existing laws and institutions encourage in equalities. Equality would

[182] Jacob Oser and Stanley L. Brue, *the Evolution of Economic Thought,* 4th edition. Orlando: Harcourt Brae Javanovich, Inc., Publishers, 1988. p. 56.

[183] Inspired by the political euphoria of the French Revolution, these two philosophers forecast the elimination of social evils. They described society devoid of war, crime, government, disease, anguish, melancholy and resentment, where every man unflinchingly sought the good of all. Ekelund and Hebert, pp. 132-133.

[184] Godwin's book: *An Enquiry Concerning Political Justice and Its Influence on General Virtue and Happiness* was therefore among the first to formulate the philosophy of anarchism – no government.

overcome the social evils of the day and lead to perfection. The only inequality that should be permitted, he thought, are those, which derive from natural abilities. Population would increase as a result of these beneficent reforms, but the food supply would increase even more rapidly. If the problem of subsistence could eventually no longer be solved this way Condorcet favoured birth control to limit the population.

Hence, when Malthus wrote his *Essay on Population* it was to counter or deny the contention of Godwin-Condorcet that goodwill and education alone were capable of bringing about a perfect social order. Poverty had its roots not in social and political institutions, but in the unequal race between population and the means of subsistence. Moreover, nothing could stem the tide of numbers except the voluntary limitation of family size by the poor themselves. Thus, in one stroke, Malthus accounted for the existence of poverty, exposed the panaceas of visionary reformers, and provided a touchstone for every question of policy relating to the labouring poor[185].

This population dilemma posed both a theoretical and a practical question. The theoretical question centred on identification of the actual checks to population growth; the practical question concerned solutions to the problem, namely which checks should be encouraged over others. The ultimate check on population growth is limited food supply, but there are others, which Malthus classified into positive and preventive checks. Under the positive checks are factors which increase death such as war, famine, misery, pestilence [plague] while under the preventive check are factors that reduce birth such as moral constraint, contraception and abortion. Given his background, Malthus *approved only the moral constraint.*

The outcome of the Malthusian population-food supply struggle inevitably leads to subsistence economy. This view was unfortunate for two reasons; as prophesy, it was proved to be wrong in many instances, and it is not at all inherent in the theoretical structure devised by Malthus. By way of explanation one may distinguish between Malthus's population *theory* and his population *trap.* The theory is capable of explaining all manners of population changes: growth, depopulation, or stagnation. The Malthusian trap, on the other hand, implies the actual attainment of a subsistence economy because the tendency to procreate has in fact dominated the cumulative effect of the checks in force.

[185] Blaug, *Great Economists,* p. 142.

Malthus often seems to have asserted that the trap is inevitable, although, in fact, the countries with advanced economies have so far managed to avoid it.

A more serious shortcoming of the Malthusian population theory was this tendency, shared by other classical writers, to underestimate the advance of agricultural technology. In his *Essay on Population*[186], Malthus had hinted that agriculture is subject to diminishing returns, a topic which he later expanded in his theory of rent. As an economic law, however, diminishing returns holds only for constant state of technology. And in the advanced economies rapid progress in technology has so far succeeded in forestalling the Malthusian trap.

The Theory of General Gluts[187]

Malthus developed his theory of the potential inadequacy of aggregate demand in Book II of his *Principles of Political Economy*. He assumed that workers receive a subsistence wage. Employers hire these workers because they produce a value greater than that which they receive as wages: that is, the employer makes a profit. Since the workers cannot buy back the total output, others must. The profit cannot be returned to the workers in the form of higher wages because the disappearance of profits causes production and employment to cease. So who will purchase the extra output? Capitalist will buy some of it in the form of capital goods. Spending on capital good stimulates production and employment, as does spending on consumption goods. According to Malthus, the consumption by workers employed is in productive labour can never alone furnish a

[186] Although his Essay transformed Malthus into an intellectual celebrity, many reviled him as a hard-hearted monster, a prophet of doom, an enemy of the working class, etc. The ridicule and invective rained down on Malthus was relentless. But sufficient number of people recognised his *Essay* for what it was: the first serious economic study of the welfare of the lower classes.

[187] Ricardo and J.S.Mill did not support the general glut theory. In response to Malthus on this issue, Ricardo said that mistakes can be made, and commodities not suited to demand may be produced – of these there may be a glut and that it is at all times the bad adaptations of the commodities produced to the wants of mankind which is the specific evil, and not the abundance of commodities. Demand is only limited by the will and power to purchase.
An interesting offshoot from the debate was to use general gluts as a theoretical basis for colonising projects. Some interested characters had concocted a scheme of systematic colonisation as a way to relieve both surplus labour and excess saving. Staley, p. 74.

sufficient motive to the continued accumulation and employment of capital. Investment is undertaken in the final analysis only to provide consumption, and if the final products cannot be sold, no investment will be forthcoming. To be sure, capitalists have the power to consume their profits, but it is not their habit to do so. The central objective of their lives is to amass a fortune, and they are too busy in the counting house to consume it all. It is worthy to note that in the *Principles of Political Economy*[188], Malthus implied that war offered another stimulus that could eliminate gluts [business depressions].

The Need for Unproductive Consumption - Spending by landlords is done to avoid the glut of goods on the market, which in turn could produce economic stagnation. Even so, a general glut may occur if the wants of consumers become satiated. Rent, said Malthus, is surplus based on the difference between the price of agricultural produce and the costs of production (wages, interest, and profits). Its expenditure therefore adds to effective demand without adding to the cost of production. The other forms of income increase purchasing power but also raise production costs, and costs must be kept down if a nation is to maintain its competitive position in world markets.

Policy Implications - The theory of general gluts and the need for unproductive consumption had several policy implications. The most important one, according to Malthus, was that *Corn Laws* must be retained. These tariffs on imported grain enrich the landlords and consequently promote unproductive consumption. The latter is necessary to avoid economic stagnation.

While Malthus favoured unproductive consumption by the landlords, including hiring of large numbers of menial servants, he opposed excessive unproductive consumption financed by the government. Government officials, soldiers, sailors, and those who live from interest on the national debt necessitate higher taxes, which might impede increase of wealth. Society should consider private property sacred, and it should not allow the redistribution of wealth through excessive taxation. Nor is a growing government debt desirable, because the inflation it promotes will hurt those on fixed incomes.

[188] Almost from the beginning of his career as an economist Ricardo was a devotee to Say's Law. In his *Principles* Malthus set down, as carefully as he could, his objection to the contents of Say's Law.

Iron Law of Wages

Malthus had made further contribution to the economic field in his *Critique of Accumulation* and the *Iron Law of Wages.* The latter formed the core of the labour wage concept among classical economists. Real wages, Malthus said, could not rise above the level of subsistence because an increase in wellbeing would lead to a larger supply of workers, and when wages fell below this level, the surplus workers would be eliminated by death. This concept has come to be known as *the iron law of wages*.

8.4 David Ricardo (1772-1823)

Introduction

David Ricardo was born in London from a family that descended from Iberian Jews who had fled to Holland during a wave of persecutions in the early 18th century. His father a stockbroker immigrated to England shortly before Ricardo's birth. David Ricardo was the third of seventeen siblings! At the age of fourteen he started working with his father, who had become a successful member of the Stock Exchange. At 21, he married the daughter of a Quaker against the wishes of his parents, who promptly disinherited him.

However, with the assistance of some acquaintances and on the strength of his considerable reputation in the City of London, Ricardo managed to set up his own business as a dealer in government securities. He became immensely rich in a very short while. In 1814, at the age of 42, he retired from business, purchased an estate and began to devote himself to literary pursuits[189]. In 1819, urged by his fried James Mill, he got himself elected to parliament.

It was a chance reading of Adam Smith's Wealth of Nations that sparked off Ricardo's interest in economics! Whence he started discussing his own economic ideas with his friends, notably James Mill. Mill persistently urged him to write his ideas and Ricardo began in 1809

[189] Blaug, *Great Economists*, pp. 199-203.

getting involved in the Bullionist Controversy[190] that was raging at the time.

Ricardo's writings have dealt with various topics, such as the theory of value, the theory of wages, profits and rent, the theory of accumulation, theory of economic development and theories of money, banking and international trade.

David Ricardo, a brilliant British economist, was one of the most important figures in the development of economic theory. His classical book: *The Principles of Political Economy and Taxation* was first published in 1817, and the third edition came out in 1821. Ricardo's writings evoked the admiration of later economists some of whom

[190] In the 18th century there was a clearinghouse system of banking in the United Kingdom. At that time, private banks issued the banknotes. These bearer notes were claims on gold held by the bank – hence the common preamble, which still persists in modern Bank of England notes. At the time the promise was true. In Scotland, however, there was a slight exception. Banknotes often had a clause that allowed the bank to suspend convertibility. The suspension clause was a way that system responded to the bullying trick of the clearinghouses. An intellectual debate proceeded immediately as lawyers, bankers and statesmen lined up for and against the maintenance of convertibility of notes into gold. On the one hand were the Bullionist group, which argues for convertibility; arrayed on the other side were Anti-bullionist who preferred the status quo of suspension.
The Bullionist argument was straightforward. If banks are not required to convert notes into gold, then they will be tempted to issue notes in excess of the gold in their vaults. This will lead to an excess supply of money, hence a cheapening of the price of money - inflation. Ricardo was amongst those who argued for the convertibility of the notes.
The Anti-bullionists appealed to some form of Real Bills Doctrine [that essentially the supply of money is not exogenous but rather and endogenous, because banks create money according to the needs of the trade]. Hence as long as the repayment of bills of exchange is credible then no more banknotes will be issued than what is required by merchants. The demand for banknotes by commerce in itself is limited by the needs of trade, hence even without convertibility, the bank is not going to issue more notes than what commerce demands. Following the Scottish tradition, John Law, Sir James Steuart and Adam Smith argued against convertibility.
The Bullionist Debate, with a sight difference, re-emerged in the 1840s ad 1850s after the banking Act of 1844 gave the Bank of England the monopoly on note issue. While not requiring convertibility, the Bank of England was required to maintain a specific par between note issue and gold reserves held at the Bank. Hence, those supporting the Act were known as the Currency School [led by Lord Overstone] while those who rallied against the Act were called the Banking School [led by Thomas Tooke but including John Stuart Mill. The Banking Act was suspended three times, but the Banking School won the day because it was in operation until the First World War.
Source: http://cepa.newschool.edu/het/school/bullion.htm

considered that he had a greater insight into the working of the economic system than his predecessor, Adam Smith[191]. Other economists described his major work as the source of inspiration of agitators and descriptors of society. In addition to this, he wrote a large number of essays of which his first pamphlet *The High Price of Bullion a proof of the Depreciation of Bank Notes*[192] was written in 1810. His essay on the Corn Law controversy, published in 1815, established him as one of the most able economists. His work is still fascinating present day scholars as indicated by *The Works and Correspondence of David Ricardo* published in 1951[193]. According to Blaug, with the exception of Karl Marx, no great economist of the past has received so many divergent and even contradictory interpretations as David Ricardo.[194]

The Theory of Value and Distribution

Ricardo was the first to develop a theory of value and integrate it with a theory of distribution and thus heralded what was to become the principal concern of the nineteenth-century economic theory: value and distribution. The central problem posed in his work was how changes occur in the relative income shares of land, labour and capital and what effect these changes have on capital accumulation and economic growth. The determination of rent was an integral part of this problem[195].

In Ricardo's theory, *the value a commodity, or the quantity of any other commodity for which it will exchange, depends on the reactive quantity of labour, which is necessary for its production, and not on the greater or less compensation, which is paid for that labour*[196].

[191] Ricardo represented a change in the methodology of economics from Smith's loose combination of theory and historical description to abstract, deductive theoretical models. Landreth and Colander, p.147.
[192] In this pamphlet he espoused a narrow quantity theory of money, which precluded the acknowledgement of a connection between changes in the quantity of money and changes in output. Spiegel, p. 315.
[193] Landreth and Colander, p. 99.
[194] Blaug, *Great Economists,* p. 199.
[195] Ekelund and Hebert, p.149.
[196] David Ricardo, On the Principles of Political Economy and Taxation, in *The Works and Correspondence of David Ricardo,* Piero Sraffa and M. H. Dobb, (eds). Cambridge: Cambridge University Press, 1953., p.6. Quoted in Landreth and Colander, p.117.

To Ricardo as to Smith, value is primarily exchange value rather than use value, and exchange value has three constituent elements – utility, scarcity and labour – embodied in the good whose value is to be ascertained. As for utility, no good that fails to be useful can have exchange value, but utility does not measure exchange value. As for scarcity, it alone will determine the value of goods that cannot be reproduced by labour, such as paintings and statutes that are masterpieces and rare books and coins[197].

Adam Smith had explained that in the early stages of society preceding the appropriation of land accumulation of capital, the relative values of such things depended upon the quantities of labour expended in procuring them. In this, Ricardo agrees with Smith, but differs in maintaining that even after land has been appropriated and capital applied to industry, relative values depend upon the quantities of labour required, the same as before. Smith thought that in modern times other elements than labour affect the comparative value of commodities; he found it influenced by wages, profits, and rent[198].

Ricardo rejected Smith's alternative version of the *standard measure of value,* that of labour commanded. He stated that labour embodied and labour commanded are by no means equal, and labour commanded is a highly variable quantity, being subject to changes in the demand and supply of labour and in the prices of wage goods. He has also no use for the corn standard, which Smith had discussed, again because of the variability of such a yardstick, whose value will change with agricultural conditions, population and public policies affecting its importance[199].

Ricardo's recognition that not only the amounts of labour embodied but wages and profits as well affect exchange values makes it possible to interpret his value theory, not as is done conventionally as a labour theory but as a cost-of-production theory, albeit one that excludes rent. Nevertheless, Ricardo's great impact on the history of economics was made as an exponent of the labour theory of value, not of a cost-of-production theory.[200] Ricardo applies his theory of value to money as well by considering the value of money in terms of commodity theory of money.

[197] Spiegel, p. 320.
[198] Haney, pp. 286-287.
[199] Spiegel, pp. 320-321.
[200] ibid., 321.

The Theory of Wages

Ricardo took over Malthus' Iron *Law of Wages* and systematised it. Wages he held, could never be far from the level necessary to maintain a *minimum of subsistence,* because of the action of *demand and supply* in the labour market: higher pay would increase the supply of labour, lower pay would decrease it[201]. Ricardo, in analysing the cost of subsistence, maintained that it depended mainly on the price of food and other farm products. Higher crop prices, he thought, necessitated higher wages, and higher prices of crops, in turn, were due to rent, which rose as a nation became fully populated and the best land was exhausted. He maintained that the subsistence or natural wage is not absolutely fixed but varies with time and place, reflecting habits, customs, and institutions that are subject to change.

Ricardo argued that landlords in charging higher prices for the means of subsistence were exploiting, not labour, but the employer who had to pay higher wages. The employer could not offset the increase of wages by charging higher prices for his products, since the prices received were determined at a competitive market. Thus, Ricardo maintained that employers would have to keep wages as low as possible if they were to remain in business.

The above analysis led Ricardo to state that profits from business transactions go, to a great extent, to landlords who by charging higher prices for the means of subsistence exploit, not only the labour force but also employers.

The Theory of Rent

The theory of rent reflects the operation of both the differential principle[202] and the marginal principle, which related to the cost of production. According to the differential principle, production costs differ for outputs produced on different plots of land as well as for outputs produced with the help of varying doses of inputs of capital and labour on the same plot of land. According to the marginal principle the exchange value of output is always regulated by the cost of production incurred under the most favourable circumstances. The price of a crop will thus

[201] ibid., 325.
[202] This is the principle of diminishing returns.

cover the cost of production incurred at the least fertile and least favoured location but whose output is still needed to satisfy the existing demand. In the light of this analysis, rent is a surplus that accrues to the owner of land, which is cultivated under conditions of cost more favourable than those prevailing at the margins[203].

Ricardo agreed with Adam Smith in the concept that rent[204] was a monopoly price but he elaborated it further, as indicated above. He argued that if land was as abundant as air, then it would have been appropriated by anyone who wanted it and it would command no price: it would be a *free good.* However, as the first farmers took possession of the best land, and with the exhaustion of the best or fertile land, others had to appropriate those lands, which were not fertile. Thus, the least fertile land would be cultivated only if it would pay for the labour necessary to work it. It would yield just that and no more. It follows therefore, that the rent charged for the better land would not be a payment for labour, but rather a payment resulting *from mere ownership* of a scarce form of natural resources. Thus, rent is the result of the niggardliness of nature, which causes diminishing returns on land and which keeps some lands less fertile than others[205].

The Theory of Profit

Ricardo's theory of profits is developed as a corollary of his theories of wages and value. Money wages rise in the course of economic development, reflecting the rise in food prices, which accompanies the increase in labour required for agricultural production. The prices of manufacturers, on the other hand, remain at its established level – the production of these requires no additional quantity of labour. Hence, Ricardo pointed out: *as money wages increase, profits are bound to fall. Profits depend on high or low wages, wages on the price of necessaries, and the price of necessaries chiefly on the price of food.* The fall in the rate of profits will in the end usher the 'stationary state'[206].

[203] Spiegel, p. 324.
[204] Adam Smith and the Physiocrats assumed that rent was a gift of nature.
[205] Ricardo did not consider the locational aspect of rent theory, a gap, which was filled in by later day economists, especially the German economist Von Thunen in 1826.
[206] Spiegel, p. 326.

Other Contributions

According to Ricardo, political economy should be regarded as an inquiry into the distribution of the proceeds of the productive process rather than an exploration of the cause and nature of a nation's wealth. He thus divided the wealth acquired into *rent, wages, interest and profits* to be distributed, respectively to *land, labour, capital* and *entrepreneurship*.

With regard to *accumulation*, Ricardo shared the view of Jean Baptiste Say, who held that every *supply* involves *demand,* and that products exchanges products, and that every commodity put on the market creates its own demand and every demand exerted in the market creates its own supply.

Though Ricardo left to posterity significant ideas on money, interest and banking, his important contribution to the economic field, as we have seen above, is his theory of rent. Likewise, his writings on international trade are also regarded as an important contribution to economic knowledge. He developed further Adam Smith's contention that international exchange pays both parties engaged in the trade inasmuch as each party exchanges with the other those commodities in the production of which it has a comparative advantage.

He contended that as profits can vary only in response to variations in wages, there could be no direct effects of foreign trade on profits. However, as an indirect effect of foreign trade, profits will increase if wage goods, especially food, imported from abroad at prices lower than would be charged for domestically produced goods and if, in consequence of this, wages fall[207].

Ricardo who said of wages that *like all other contracts*, they *should be left to the air and free competition of the market, and should never be controlled by the interference of the legislature* would see no other remedy to stem the arrival of the stationary state than strict adherence to laissez faire. Thus he went on to develop the most powerful argument in favour of free trade that based on the principle of comparative advantage.[208]

[207] ibid., p.329.
[208] ibid., p. 328.

8.5 Jeremy Bentham (1748-1832)

Introduction

Born in 1748 son of a wealthy solicitor, Jeremy Bentham, had a solid educational background, and became a well-known English social philosopher of his time. Though he studied law he did not practice as a lawyer, however, he took advantage of an inherited income to devote his life to the reform of English Common Law. He led a simple life without great passions.[209]

Bentham based his social philosophy on the concept *the greatest good to the greatest number.* He believed that every social institution should be tested by its usefulness in increasing the good to individuals; it could be judged by its efficacy in promoting the greatest utility to the largest number of members of the community. Hence, Bantam's philosophy has come to be known as *utilitarianism.* In reply to the question "how was good to be measured?" he asserted that anything which increased the leisure or diminished the pain of any person was good. This view concord with *epicurianism*- a philosophy named after the name of its expounder, Epicures, a great ancient Greek thinker, though the latter stressed the *mental attitude* more than the physical comfort of the individual aimed at by Bentham. But how can individual or social good or comfort actually be measured? Bentham believed that the common and convenient measure was money. Enough money, he argued, brings happiness while lack of money was responsible for a person's misery. But the wealth of an individual in excess of *sufficiency* does not increase his pleasure proportionally. The same amount of wealth, if available to the poor, would certainly bring a much larger sum of happiness. Though Bentham differed in method, his logic led him to reach the same conclusion as that of the socialists: the desirability of greater equality of wealth.

He refuted Adam Smith's belief in the *beneficence of nature* and accused him of *mystical absurdity*. In order the maximise utility, he thought it was necessary to empty reason in the discovery of the best policy to bring about the desired end. Economics, he contended, was not merely a

[209] He fell in love with a young girl but dared to propose to her [in writing] only twenty-five years later, and again when he was almost eighty, but was both times refused. Quoted in Jurg Niehans, *A History of Economic Theory, Classic contributions, 1720-1980*. Baltimore: Johns Hopkins University Press, 1990. pp. 124-125.

science designed to analyse what existed, but it should also be taken as an art in the shaping and conditioning of human affairs so as to bring about the maximisation of the social good. Men, he argued, could not rely on a *personified nature* to perform this task for them.

Even though his reasoning appears to have led him to endorse *quietism* by the state as the best policy, it would lead others to advocate state intervention in economic life. Benthan, however, did not confine himself to writing; he was prominent among the *philosophical radicals,* who actively participated in the promotion of the British Reforms of the period. Notable among the reforms obtained as a result of his activities are those, which repealed government interference, such as *prohibition of organisation of labourers and discrimination against Catholics and Dissenters.* To these must be added, other reforms for which he activated the state: the *extension of popular education and of the right to vote; the promulgation of Public Sanitation and Hygiene; a new Poor Law;* the famous *Reform Bills of 1832, and the Municipal Corporation Act of 1835.*

Bentham's Contribution

In his lifetime he published a few highly effective economic pamphlets, such as *Defence of Usury* (1790), and *Supply Without Burthen* (1795), and a number of his incomplete economic manuscripts circulated among friends and admirers. Nevertheless, his ideas on economics were so far ahead of his time or at least so out of tune with his times that it is doubtful if they had much impact on his contemporaries. For example he showed an extraordinary awareness of the problem of unemployed resources, and in advocating monetary expansion to secure full employment, he employed a number of concepts that bear a family resemblance to those of J.M.Keynes, such as hoarding, forced saving and the equality of saving and investment. Moreover he gradually shifted from an early phase of extreme Toryism [denying that even the money market should be regulated by government] to an equally extreme Whiggism [advocating guaranteed employment, minimum wages and a variety of social benefits]. His deliberations on the measurement of utility, interpersonal comparison of utility and the principle of diminishing marginal utility, while virtually unknown to his

contemporaries, proved stimulating to later generations, and in the case of Jevons inspired him to develop the utility theory of value[210].

Bentham's specific contribution to economic theory was the reinvention of Bernoulli's principle of the diminishing marginal utility of income (or wealth). Like Bernoulli he thought that equal absolute increments in utility would require equal proportionate increases in income, which implies that utility is a logarithmic function of income. Combined with the assumption of interpersonal comparability of utilities, it is clear that this principle gave Bentham's thinking a strong egalitarian bent[211].

8.6 Jean-Baptiste Say (1767-1832)

Introduction

Jean-Baptiste Say was born in Lyons in a Protestant merchant family and came eventually to run a cotton plant himself in Northern France. In his youth he worked for an insurance company, then edited a journal, and eventually became a member of the Tribune under the Consulate of Napoleon. In 1815, after the fall of Napoleon, he began to teach the first public course of political economy ever given in France. Two years later he was appointed to a professorship in industrial economics at the Conservatoire des Arts et Metiers, succeeding in 1830 to the first Chair of Political Economy in France, at the College de France in Paris. He visited England many times in his career and was a close friend of both Ricardo and Malthus, which did not however imply total agreement with all their teachings[212].

His *Traité d'Économie Politique* (1803), 'which had made him the principal apostle of Adam Smith in Europe and North America,'[213] went through many editions was translated into several languages. One of the most important influences of the book was the way Say systematised and organised economic principles into the broad categories of production, distribution, and consumption. This order was followed by later major

[210] Blaug, *Great Economists*, pp.16-18.
[211] Niehans, pp. 125-126.
[212] Blaug, *Great Economists*, pp.211-212; Haney, p. 356.
[213] Spiegel, p. 258.

writers such John Stuart Mill (who added the categories of the progress of society and government)[214].

Theory of Value

According to Say, utility is defined as the inherent capability of things to satisfy human wants, and value is said to originate in utility. Price is the measure of utility, so long as the buyer pays no more than his estimation of the utility of his purchase[215]. Say opposed the labour theory of value of the Classical School[216], replacing it with supply and demand, which in turn are regulated by costs of production and utility. Thus, in some respects his analysis was more advanced than that of Ricardo. Say's discussion of supply and demand, however, did not include development of schedules showing price-quantity relationships, as did that of Marshall. Instead the terms supply and demand were used quite loosely and imprecisely.

Say's Law of Markets

Say is known as the writer who developed the law of markets[217], named after him, which to this day figures prominently in the discussion of economic theory. His law is taken from the statement, depending on the version cited, *….it is production which opens a demand for products…Sales cannot be said to be dull, because money is scarce, but because other products are so…a product is no sooner created, than it, from that instant, affords a market for other products to full extent of its*

[214] Staley, p. 72.
[215] Haney, p. 357.
[216] Say finds fault with Smith for attributing only to labour the power of producing value. To Say, it is human industry, combined with nature and capital, that produce value. Thus Say introduces the threefold division of the factors of production into labour, land, and capital, a division that was to become the standard in 19th century economic literature. Spiegel, p. 259.
[217] Blaug states that Say did not originate Say's law of markets, and that history was too kind to him. What Say stated in his Treatise is that *…products are always exchanged for products*, but it was James Mill, in his *Commerce Defended* (1807), who turned this into *supply creates its own demand*, who drew from it some of its implications; for example, gluts or trade depressions are never due to overproduction and that the role of money is of secondary importance in accounting for the phenomena of exchange. Blaug, *Great Economists, p. 209.*

own value[218]. On the basis of this proposition, Say's thought is interpreted as having contained a denial of the possibility of general overproduction.

Say's chief claim to fame rests on his theory *that general overproduction is impossible*[219]. Although challenged by Malthus and Sismondi, Say's law continued to dominate economic thinking until Keynes refuted it in 1936. Say maintained that there may be a general over production and glut, is an unsound a generalisation from particular experience. Generalised, there can be no such thing, for selling is at the same time buying, and in producing, men are creating a demand for other goods[220]. Uncritical acceptance of this law of markets appears to have delayed the study of business cycles for many decades.

While Smith, James Mill, and Say were wrong in assuming that the economy always tends toward full employment, there is a certain long-run validity to this doctrine. Underdeveloped economies are characterised by low output and corresponding low-income payments to people. As an economy grows, it simultaneously generates an increased supply of goods and increased demand for goods; similarly, in international trade, as a country produces more, it can export more, and therefore it can afford to import even more. Both in domestic and in foreign trade '*supply creates its own demand* in the long run. This principle does not hold true, however, in the short run in market-based economies. Even though payments to factors of production would be enough to buy all the goods produced, there is no guarantee that the recipients of these income payments will spend them on the existing output.

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[218] Spiegel, p. 260. James Mill made a similar statement in a pamphlet he wrote in 1807 called *Commerce Defended:*

> *…. but a nation's power of purchasing exactly measured by its annual produce, as it undoubtedly is; the more you increase the annual produce, the more by that very act you extend the national market, the power of purchasing and the actual purchases of the nation…..It may be necessary, however, to remark, that a nation may easily have more than enough of any one commodity, though she can never have more than enough of commodities in general.* Quoted in Staley, p. 72.

[219] Say and his colleagues argued that *in the process of producing goods, sufficient purchasing power is generated to take these goods off the market at satisfactory prices. They maintained that overproduction might occur in particular markets but that it was impossible to have a general overproduction for the entire economy.* Landreth and Colander, pp. 135-136.

[220] Haney, p. 356.

8.7 Nassau William Senior (1790-1864)

Introduction

Nassau William Senior, the eldest son of a country clergyman, who had ten children, was born in Berkshire, England. He was educated at Eton, Oxford and Lincoln's Inn, London. In 1817 he was certified and in 1819 he was called to the bar. However, law practice did not suit his temperament and after some postgraduate work in political economy, he was named the first endowed chair of political economy at Oxford in 1825. Appointed to various governmental commissions in the 1830s and 1840s, Senior was instrumental in shaping legislative reforms in education, factory conditions, and the Poor law. Chief among his published work was *An Outline of the Science of Political Economy,* first printed in 1836 and revised by Senior in 1850. *Political Economy* suffers from a lack of organisation and consistency, and yet it is an important milestone in the history of economics, not only for its criticism of Ricardian economics but also for its original contributions[221]. He published a few more lectures and wrote large parts of a treatise on political economy, which he never finished. He began to travel widely and kept a series of travel journals, some of which he published himself but many of which were only published after his death.[222]

Economic Postulates[223]

In the nineteenth century there were three Englishmen whose work provided the main stepping-stone between Adam Smith and John Stuart Mill: Ricardo, Malthus and Nassau Senior. In these and other lectures published separately, he made original contributions to the theory of value, rent, population, money and international trade[224]. In addition, he had pronounced views about the nature and scope of economics and the functions of the economist. He felt that, political economy, which treats of wealth, must be sharply distinguished from the science of legislation, which has happiness or welfare as its subject. Wealth and welfare are by

[221] Ekelund and Hebert, p. 158.
[222] Blaug, *Great Economists*, pp.220-222
[223] Senior was one of the first economists to maintain unequivocally that economics should be a positive science. He maintained that the economist as a scientist should be able to distinguish between normative judgements and positive economic analysis.
[224] Blaug, *Great Economists*, p. 220.

no means identical matters, and the economist must always remember that considerations of wealth are not the only and not even the most important elements in the solution of policy questions[225].

In his economic thinking he departed significantly from classical economics and moved toward the neo-classical position that triumphed after 1870. He is credited with the initiation in Great Britain of the utility-based demand and the cost of production based supply scheme, thus an important predecessor of the *marginalist revolution*. Furthermore, in his sub-division of the science of economics, it seems clear that he foreshadows Mill's distinction between the laws of production and distribution.

Senior wished to separate the science of political economy from all value-judgements, all policy pronouncements, and all efforts to promote welfare, that is, the distinction between normative and positive economics. He also promoted greater methodological sophistication among Ricardo's followers by attempting to derive all the propositions of political economy from four axioms about economic motivation and the technology of industry and agriculture. These are: a universal desire to obtain more wealth with the least sacrifice [*principle of income utility maximisation*]; that the population of the world is limited only by moral or physical evil or by fear of deficiency of the articles of wealth which the habits of the individuals of each class of its inhabitants lead them to require [*the Malthusian principle of population*]; the postulate that the powers of labour, and the other instruments which produce wealth, may be indefinitely increased by using their products as a means for further production [*the principle of capital accumulation*]; and that agricultural skill remaining the same, additional labour employed on the land within a given district produces in general a less proportionate return with every increase of the labour bestowed, the aggregate return is increased, the increase of the return is not in proportion to the increase in labour [*the law of diminishing returns from land]*[226].

[225] Spiegel, p. 352.
[226] Ekelund and Hebert, p. 159; Haney, p. 344.

Abstinence[227] and Capital Formation

Senior's most famous novelty was the *abstinence theory of profits*. By *abstinence*, Senior meant refraining from current consumption in order to accumulate capital, or *immediate* goods. This is the key to his third postulate: *that the powers of labour, and of the other instruments which produce wealth, may be indefinitely increased by using their products as the means of further production*. But since capital goods do not satisfy consumer desires directly, there is a sacrifice involved in postponing consumption unless there is a reward. Senior's contribution to capital theory was to identify this reward for *abstinence* as interest, or the cost of waiting, during which time capital could be accumulated.[228]

Abstinence is a term by which we express the conduct of a person who either abstains from the unproductive use of what he can command, or designedly prefers the production of remote to that of immediate results. In the formation of capital, some delay of enjoyment must in general have reserved it from unproductive use. This cost, then as well as the sacrifice of labour, is an obstacle limiting production, and so, through supply entering value[229].

Theory of Value

Senior's modification of the Ricardian theory of value was important. To him there were three things that should go together to contribute to value. The first is transferability or marketability, that is, unless a thing can be sold, it cannot posses exchange value in the market. However, this marketability is not co-terminus with exchange value for goods and services, which may be equally marketable need not posses same exchange value. Herein comes the second thing, relative scarcity - a more abundant thing is expected to be less valuable and vice-versa. The third determinant is the utility or want- satisfying power of goods. Thus,

[227] Senior defined abstinence as … that agent, distinct from labour and the agency of nature, the concurrence of which is necessary to capital, and which stands in the same relation to profit as labour does to wages. Quoted in Eric Roll, *History of Economic Thought,* 3rd edition, Faber and Faber, 1950, pp.349-350.
[228] Ekelund and Hebert, p. 163.
[229] Haney, p. 345.

Senior's theory of value brings together both the demand and supply sides[230].

His major departures from Ricardo thus include: an acceptance of the utility theory of value; a critique of Ricardo's cost-of-production theory, and the assumption of free competition. The chief adversary of the labour theory in the nineteenth century was always the supply-and-demand theory. Senior also adopted it, but in general he was able to handle it better, due to his recognition not only of the importance of relative utility but also the interdependence between relative utility and relative scarcity[231].

Having earlier defined economics as the science of wealth, Senior proceeded to define wealth, value and utility. Wealth, he affirmed, includes all goods and services that possess utility; are relatively scarce; and are capable of being transferred. This definition is at once broader and very modern: it recognises the pivotal importance of both demand factors [utility] and supply factors [scarcity]. Value is that quality in anything, which fits it to be given and received in exchange; to be lent or sold, hired or purchased. Utility denotes no intrinsic quality in the things we call useful; it merely expresses their relations to the pains and pleasures of mankind[232].
For Senior, demand rests on utility and in this way he came close to stating the law of diminishing marginal utility. *Not only are there limits to the pleasures, which commodities of any given class can afford, but the pleasure diminishes in a rapidly increasing ratio long before those limits are reached. Two articles of the same kind will seldom afford twice the pleasure of one, and still less will ten times the pleasure of two*[233].

Monopoly Theory

Ricardo's influence on Senior was considerable, even though they differed on several points. Senor maintained that of the three conditions of value, [utility, transferability, and limitation of supply] the limitation of supply was by far the most important. Among the factors that limit supply he regarded the existence of monopoly. Senior was opposed to the idea of

[230] Bhatia, p. 176.
[231] Ekelund and Hebert, p. 160.
[232] Nassau Senior, *Political Economy*, p.7. cited in Ekelund and Hebert, p.p. 160-161.
[233] Senior, Principles of Political Economy, p.98. Quoted in Haney, p.346.

monopoly and he considered four degrees of monopoly. First come those, which are not exclusive, but exist because a producer has the advantage of lower costs. This assumes the power to increase the product indefinitely. Secondly, there are absolute monopolies, where no increase in production is possible. The third case lies between the two, being an absolute monopoly, but one involving a product the supply of which can be increased. Finally, there is a monopoly in which the monopolist is not only the producer but has peculiar facilities, which diminish and ultimately disappear as output is increased. These four cases are important because the effect of each case on production costs either establishes or does not establish an upper and lower limit to market price and therefore, opens the way for varying degrees of demand to determine price[234].

Labour

He disagreed with Smith, who thought that the producers of services were all unproductive. Lawyers, doctors and teachers, Senior said, are productive because they promote the increase of wealth. Where a soldier must protect the farmers, both are productive. Suppose a thousand people are employed forging bars and bolts to keep out thieves; if a hundred of them can achieve the same purpose by becoming security workers instead, is wealth diminished by this conversion from *productive* to *unproductive* workers? To Senior the proper distinction was not between productive and unproductive labour, but rather between productive and unproductive consumption. The latter category includes consumption of lace, embroidery, jewellery, tobacco, gin, and beer, all of which diminish the mass of commodities without adding to the workers' capacity to produce.

Senior also devoted greater attention to the supply side while considering the obstacles that may be envisaged. He classified means of production into human labour; the spontaneous agency of nature, or land; and abstinence. On the other hand, the demand for capital flows from the fact that it is able to increase labour productivity with which it is used[235].

[234] Ekelund and Hebert, pp. 161-162.
[235] Bhatia, pp. 176-177; Haney, p. 347.

Public Choice[236]

Beginning in 1814, the British Parliament passed a series of increasingly stringent acts regulating the employment of children, adolescents [under eighteen], and adult women. Early legislative efforts were modest, but in 1833 the first effective act was passed under the sponsorship of Lord Althrop. The Act banned employment of children under nine years of age and restricted the hour and conditions of work for those between the ages of nine and eighteen. The act also provided enforcement mechanism. Senior was at the centre of the discussion.

Senior was called upon by the British government to assess the economic implications of the Althrop Act, which he accepted at its the general provisions, but came with arguments. Given the structure of a typical textile mill, he said, further reductions of hours worked would eliminate the margin of profit. The cotton industry was competitive and the average net profit per firm was 10 percent. His research revealed that given the cost breakdown between fixed and variable costs a reduction in the workday by one hour would reduce cost on working capital but not reduce fixed costs. In effect, the work reduction would force plant and equipment to be idle, and increase the fixed cost burden per unit of output. Senior felt that because of the disproportionate share of fixed costs in the total costs of manufacturing, the increase in per-unit costs by reducing the workday would wipe out the normal rate of return of the textile mills.

Senior recognised that Althrop's Act imposed an economic loss on parents of children under nine who would no longer work in textile mills, and a similar loss on the parents of children between the ages of nine and thirteen whose hours were restricted by the Act. He also noted a corresponding gain on the part of workers over thirteen. This led him to question the motives of those seeking to restrict the length of the workweek. He concluded that the factory acts were not inspired by the *public interest* so much as the interest of the (adult male) factory operatives who sought to raise their own wages.

Analytically, what lies at the heart of this issue is whether or not young workers and female workers were in direct competition with adult male workers for jobs and pay. While this issue has not been settled contemporary historians of economic thought, strong evidence exist to

[236] Based on Ekelund and Hebert, pp. 206-208

support the position that child and female labour were *substitutes* for adult male labour rather than complements. Hence, the motive behind measures that are taken need to be studied from various angles: beneficiaries and providers alike.

8.8 John Stuart Mill (1806-1873)

Introduction

John Stuart Mill was born in London, the eldest son of James Mill, himself a leading disciple and friend of both Ricardo and Jeremy Bentham. James Mill was a man of considerable eminence as a historian, a philosopher and a political economist. He was among others a friend of David Ricardo and Jeremy Bentham. He was firmly decided to make his son one of the greatest minds of his age. He believed that the human mind at birth is *tabula rasa*, and that everything depends on what is written on this blank space. Consequently he began to teach his son Greek at age three, Latin at eight. Then came philosophy, history and differential calculus. A few years later the prodigy was introduced to Smith and Ricardo. Thus, John Mill was acquainted with the major works of economics of the day by the age of twelve, and was correcting the proofs of his father's book, *Elements of Political Economy*[237] when he was only thirteen. He learnt Ricardian and Benthamite *utilitarianism* from his father. At the same time, he was expected to serve a as tutor to his younger brothers and sisters. Thus, J. S. Mill's childhood has been subjected to a regime of severe educational discipline, as expressed in his *Autobiography,* published in 1873.

If Adam Smith may be called the father of Political Economy then John Stuart Mill was his chief heir in the direct line. J.S.Mill was the last great economist of the classical school, undoubtedly the greatest since Ricardo's death in 1823. Mill made some significant original contributions and he systematised and popularised the whole body of economic thought of his predecessors. The classical school was already in

[237] Political economy does not cover the whole conduct of man in society. It is concerned with him solely as a being who desires wealth, and who is capable of judging of the comparative efficacy of means for obtaining that end. It predicts only such of the phenomena of the social state as take place in consequence of the pursuit of wealth. It makes abstractions of every other human passion or motive. Quoted in Roll, p.364.

decline during Mill's mature years, and he departed from some of the key concepts built into the classical structure by Smith and Ricardo. Thus, before his death neo-classical economics had appeared on the scene, ultimately to displace its classical forbears. Mill's *Principles of Political Economy*[238], first published in 1848, added little to economic theory, however, his formulation of the doctrines of his predecessors, together with certain illustrations and applications, was such that his book was a leading authority throughout most of the second half of the nineteenth century[239]. The book was reprinted in the United States as late as 1920, and it was the leading textbook in the field for a long time.

Mill formed the *Utilitarian Society*, which met during 1923-26, to read essays and discuss them, and in 1825 he edited Bentham's *Treatise upon Evidence.* In 1826 an acute mental crisis caused him to reconsider his own aims and those of the Benthamite School. Later, Mill rejected the latter's narrow and dogmatic utilitarianism, for he regarded Bentham's view as too limited that human beings are motivated in their conduct by nothing more than self-love and the desire for self-gratification. He charged Bentham with neglecting the human search for perfection, honour, and other ends entirely for their own sakes. Mill did not abandon the utilitarian ideas but modified them. He was concerned, for example, with the quality of enjoyment as well as the quantity.

A decisive turn came at the age of twenty-four. Mill fell in love with Harriet Taylor (1807-1858), the wife of a wealthy druggist. The friendship was, of course, sublimated at the highest platonic level. However, the arrangement created a scandal, which led to Mill's alienation from his family and to social isolation. After nineteen years of

[238] Mill was a prolific writer. His first major work was A System of Logic (1843), but earlier essays on The Spirit of the Age (1831), On the Definition of Political Economy and on the Method of Investigation Proper to It (1836), on Bentham (1838) and on Coleridge (1840) had already established his reputation as a major thinker. The Principles of Political Economy (1848) was followed by his most famous contribution, entitled On Liberty (1859), which gave full vent to one of his themes: the growth of mass conformism in social conventions and political opinions which tended increasingly to stifle the freedom of the individual. Further works on political theory appeared in 1861, followed a tract on feminism in 1865 and his Autobiography in 1873. The list does not include the hundreds of essays on logic, ethics, metaphysics, psychology and sociology that he has penned. Blaug, Great Economists, pp. 164-167.

[239] Haney, p.450.

the triangle, Mr. Taylor died and after two years Harriet became Mrs. Mill[240].

Politically, Mill was a philosophical radical on the left of the liberals. He saw himself as representing the light of reasoning against stupidity of the squires and parsons. He was a champion of civil liberties, free trade, women's rights, suffrage and voting reform. He also supported trade unions the right to strike and social legislation, but at the same time he regarded workers as far too uneducated to begin the vote[241]. Later on, Mill attributed to Harriet his humanitarianism, hope for and faith in human progress, love of liberty, and passionate defence of the rights of women. Her contributions to his general intellectual interests included the psychology of women and a deep interest in socialism and radicalism[242].

Economics of Mill

Background – when Smith was writing he was witnessing the progress of the industrial revolution all around him; and by the time of Ricardo, England had made great industrial strides and a new industrial society, with all its ramifications, had come into existence. Hence, Mill found himself in a society, which was experiencing the fruits of this industrial revolution, both in terms of production potentials and in terms of stresses and strains, human and social problems, and the manifestations of the emerging economic conflicts. For example, the landed classes were fighting a losing battle in the ensuing conflict of interests with the industrial and trading capitalists who in turn were able to lay their hands on the theoretical underpinnings of laissez faire and free trade. The overall social and political scene was now admitting fundamental changes in social values: on the one hand there was utilitarianism and on the other a case for individualism[243].

Mill's chief writing on Economics: *Principle of Political Economy with some of their applications to Social Philosophy* is divided into five books: production; distribution; exchange; influence of progress of society on production and distribution; and of the influence of government. The first

[240] Niehans, pp. 126-127.
[241] Ibid., p.127.
[242] Charles E. Staley, *A History of Economic Thought: From Aristotle to Arrow*, Oxford: Basil Blackwell Ltd., 1989), p. 111.
[243] Bhatia, p. 155.

three books cover the economic laws of a stationary and unchanging society in equilibrium, which he called *statics*. In the two final books he added the theory of motion, of progressive changes and ultimate tendencies, which he called *dynamics*. He defined Political Economy as a *science dealing with the nature of wealth, and the laws of production and distribution; including, directly or remotely, the operation of all the causes by which the condition of mankind, or of any society of human beings, in respect of this universal object of human desires, is made prosperous or the reverse*[244].

The Ricardian economics was facing criticism from at least three corners and Mill was attempting to address these. First, there was increasing evidence of a disparity between Ricardian doctrine and the empirical evidence gathered from the operation of the English economy. Contrary to the Malthusian population theory, there was increasing evidence that real per capita income was increasing as population increased; and with rapidly developing technology, agriculture was experiencing increasing and not diminishing returns. Second, economics as a discipline was becoming professionalised and consequently more critical of received doctrines. Third, a number of humanist and socialist writers, ignoring the technical content of economic thinking, delivered broadsides attacking the foundations of the emerging capitalistic economy that Ricardo's theoretical structure represented[245].

Production and Distribution[246]

Mill contended that the principles regulating the production of wealth are grounded in laws of natural science and therefore beyond human control, whereas unlike the laws of production, those of distribution are partly of human institution and thus subject to change[247].

[244] Quoted in Haney, p. 448.
[245] Landreth and Colander, p.145.
[246] Mill gave credit to Harriet Taylor for the idea that the laws of production are technological in nature but laws of distribution are man made and therefore are of a different order. However, this was an unfortunate influence as production and distribution do interact; the distribution of income affects production decisions because it influences demand, while production decisions such as the proportion in which the factors of production are used affects income. Staley, pp. 111-112.
[247] Spiegel, p. 384.

According to Mill the three factors in the process of production of wealth are land, labour[248], and capital. Wealth is defined to include all useful[249] things that possess exchange value; and cover only material objects because only these can be accumulated[250]. Thus, productive labour includes those kinds of exertions that produce utilities embodied in material objects. However, labour that yields a material product only indirectly is also held to be productive. Mill maintained that, unproductive labour is that which does not terminate in the creation of material wealth.

Mill, as Ricardo and all the classical economists had done generally, assigned a crucial role to capital and to capital accumulation[251] to the production process. Mill assumed that everything saved through abstinence by the capitalist would be invested. He stressed on the fundamental[252] propositions respecting capital, which restate the classical theory of economic progress. He argued that employment and increased levels of output are dependent on the accumulation and investment of capital[253]. Part of the investment in capital is required to tide over a discontinuous production period[254]. Unemployment of resources – other than a temporary state of affairs- was not considered possible because of Say's law.

Thus, he could not envisage lack of labour, because he said that, along Malthusian reasoning, population could increase geometrically. That it does not is due to impulses superior to mere animal instincts. People do not propagate like swine but are restrained by prudence from multiplying beyond the means of subsistence. He maintained that population is limited by *fear of want* rather than by want itself.

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[248] Mill defined it as any physical or mental effort of human beings. He further pointed out that labour may be only indirectly instrumental in certain fields of production and he enumerated the following: extraction industries; making of tools and implements; protection of industries; taking existing available supplies to the consumers; and inventions of industrial processes. Bhatia, p. 157.

[249] Useful … in the sense of being directly or indirectly instrumental to production and would include **human capital…**. ibid., p. 157.

[250] Haney, p. 450.

[251] Ekelund and Hebert, p. 175.

[252] The four fundamental propositions of capital are that: industry is limited by capital; saving is the source of capital accumulation; saving is effected for future consumption; and productive labour is employed and supported by capital. Bhatia, p. 159.

[253] ibid., p.152.

[254] ibid., p. 152. Mill later on recanted this belief in the wage fund theory.

In Book II and III, *Distribution and Exchange*, were introduced a secondary role of parcelling out this predetermined block of wealth, national dividend, among different individuals according to the prevailing system of economic organisation. It was not thought that distribution and exchange could directly affect the size of the national dividend. Mill indicated the distinction between the laws of production, which are immutable physical laws and the laws of distribution and exchange, which pertain to existing social institutions[255]. He stated that

> *..... The laws and conditions of the production of wealth partake of the character of physical truth. There is nothing optional or arbitrary in them. Whatever mankind produce, must be produced in the modes and conditions imposed by the constitution of external things and by the inherent properties of their bodily and mental structure. The opinions, the wishes, which may exist in these matters, do not control the things themselves. ... It is not so with the distribution of wealth. That is a matter of human institutions solely. The things once there, mankind, individually or collectively, can do with them, as they like…The distribution of wealth, therefore, depends on the laws and customs of society* [256].

With this deterministic theory of production, there was a shift of emphasis from Adam Smith's concept of wealth as a flow of *annual produce* or the national dividend to the concept of wealth as a stock, the national capital. Since the size of the physical output was supposed to follow as a determinate technical function from a given stock of resources and technique, the wealth of society could simply be measured by measuring the physical magnitude of its capital stock. Hence, more than any other classical economist, Mill made it a principle to exclude immaterial services from his philosophically correct definition of wealth as *instruments, meaning not only tools and machinery alone, but the whole accumulation possessed by individuals and communities for the attainment of their ends*[257].

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[255] Hla Myint, *Theories of Welfare Economics,* London: Longmans, Green and Co., 1948, p. 10.

[256] Quoted in Myint, p. 10; Bhatia, p.166.

[257] *It is essential to the idea of wealth to be susceptible to accumulation; things which cannot, after being produced, be kept for some time before being used are never regarded as wealth, since however much of them may be produced or enjoyed, the person benefited by them is no wise richer, is no wise improved in circumstances.* [*Principles,* Book II, p. 47]. Quoted in Myint, p. 11.

Mill failed to recognise that production and distribution are interrelated and that interference with one involves interference with the other. The *things* are not there as a mass of goods already produced. They appear as a continuous flow that gets produced through the incentives provided by payments to the factors of production. The flow can get reduced or completely interrupted if the distribution of income is unfavourable to the maintenance of production.

Although the quotations are exaggerations, they allowed Mill to raise the prospect of a greater role for the political process in deciding on the proper distribution of income. It can be said, to Mill's credit, that he abandoned Ricardo's idea of inexorable *laws of distribution*, under whose rule humanity is helpless. Mill flung a challenge at the classical school's belief in the universality and permanence of natural law. This rationalised his defence of limitations on inheritance for distant relatives and his support for other measures, which would promote a broader diffusion of ownership of wealth. While he was basically committed to a private enterprise, profit–oriented economy, he welcomed "profit sharing" and "producer co-operatives" as methods through which workers could enhance their wealth.

Wages

Mill, like Senior, Ricardo. James Mill, and Smith before him, accepted the wages-fund notion throughout the successive editions of his *Principle,* however in response to criticism by William Thornton, a friend and associate, he recanted in an article published in 1869[258]. His ambivalence[259] continued because in his response he did not change his view about the need for control of population and he did not modifying his presentation of the wages fund theory in the next edition of his book, which was to be the last in his lifetime. Wages, he said, depend mainly upon labour demand and supply. The demand for labour depends on that part of the capital set aside for the payment of wages. The supply of labour depends on the number of people seeking work. Under the rule of competition, wages cannot be affected by anything but the relative amounts of capital and population. Wage rates cannot rise except by an increase of the aggregate funds employed in hiring labourers or by a

[258] Spiegel, p. 390; Bhatia, p. 162..
[259] Bhatia, p. 162.

decrease in the number of workers employed. Nor can wage rates fall except by a decline of the funds devoted to paying for labour or by an increase in the number of labourers to be paid. This theory therefore presupposes a unitary elasticity of demand for labour; no matter what the wage rate, the same sum is expended for labour.

It follows then, according to Mill, that government cannot increase total wage payments by fixing a minimum wage above the equilibrium level. Given a wages fund of a fixed size, the higher wage income, which some workers would receive, would be offset entirely by the lost wage income of those who became unemployed. To remedy this condition the government can increase the size of the wages fund by instituting forced saving through taxation, using the proceeds to overcome the unemployment created by minimum wage laws. Mill recognised that this would have the side effect of removing the restraining influence on the procreation of poor. *But no one has a right to bring creatures into life, to be supported by other people*.

The wages fund doctrine provided a basis for opposing unionism, although Mill did not use it for this purpose. Workers cannot raise their incomes through collective action. If one group raises its wage rate, wages must fail elsewhere. Mill, passionately devoted to liberty, argued that workers should have the right to combine to raise wages even though he considered unions seldom effectual, and when effectual, seldom desirable.

The wages fund concept was erroneous because there is no predetermined proportion of capital that must go to labour. The idea of a fund arose because the harvest of one season was used to provide subsistence for labour for the following year. But once a business gets established, wages are paid not from an advance fund of so-called circulating capital but rather from a current flow of revenue derived form the sale of output. Later economists pointed out that the decision to hire a worker is based, not on the availability of past revenue, but on the prospective revenue that the firm will earn by selling the output that the worker helps produce.

Mill supposedly repudiated the wage-fund theory[260] as indicated above in a book review he published in *Fortnightly Review*. Because he stated that Unions could raise the general level of wages. Their own higher wages

[260] In his 1869 review of a book *On Labour* Mill undid the fixity assumption of the wage-fund by introducing some upper limit. Ekelund and Hebert, p. 192.

might bolster the ranks of the morally fittest workers who had fewer children, and the resulting unemployment might increase the mortality of the class of workers who would tend to have larger families. If this were the case, population would fall relative to the size of the wages fund and the overall level of wages would rise. In any event, Mill came to the conclusion that the real limit to increase in wages comes at the point at which the employer would be ruined financially or driven to abandon the business, if wages were increased further.

Two additional ideas presented by Mill merit mention. The first is that profit resolves itself into three parts: interest, insurance, and the wages of superintendence. These are the rewards for abstinence, risk, and exertion implied in the employment of capital. Allowing for differences in risk, attractiveness of different employments and natural or artificial monopolies, the rate of profit in all spheres of the employment of capital tends toward equality. The second is that like Smith before him, Mill noted that expenditures on education and training partly represent investments justified later by wage returns. Today these expenditures are referred to as investments in human capital.

Theory of Value

The distinction between use value and exchange value had been known for some time and Mill had nothing to add to it. However, he introduced a threefold classification of commodities: those which are absolutely fixed in supply; those which can be increased to any extend desired subject to demand; and those whose supply could be increased at increasing costs[261].

The Ricardian theory of value runs in terms of relative cost of production in labour terms, while Mill's theory was basically a cost of production theory. He noted that price expresses the value of a thing in relation to money: the value of a commodity is measured by its general power to purchase other commodities. There can be a rise of prices but not a general rise of values, for in relative terms all things cannot rise in value simultaneously. Also, the value of a commodity cannot rise higher than its estimated use value to the buyer. Effectual demand – desire plus purchasing ability - is therefore one determinant of value. But differing quantities are demanded at different values. If demand depends partly on

[261] Bhatia, pp. 159-160

value and value depends on demand, is this not a contradiction, asked Mill. He resolved it by introducing the concept of a demand *schedule* (relationship between price and the quantity demanded), and by so doing greatly advanced value theory. The quantity demanded is what varies according to the value (or price). The market value gets determined through the interaction of supply and demand and once this value is established, the quantity demanded gets determined[262].

Mill had a definite understanding of supply and demand schedules, elasticity of supply and demand, and their influence on prices[263]. These were significant concepts on which Alfred Marshall built further in his elaboration of marginalist principles. With respect to elasticity of supply, Mill classified goods into three categories. The first is "of things absolutely limited in quantity, such as ancient sculptures or pictures". This is a case of perfectly inelastic supply: price changes do not result in changes in the quantity supplied. The value of such goods is regulated by demand and supply, with demand being of greatest consequence. The second category of goods refers those for which supply is perfectly elastic, and the majority of all things bought and sold fit into this category. Production can be expanded without limit at constant cost per unit of output, and values of such commodities depend on supply, or costs of production. The third category of goods is composed of goods with a relative elastic supply – those, which fall between the two extremes. As Mill put it, *…only a limited quantity can be produced at given costs.* This is especially the case in agriculture and mineral products, which have rising costs of production. Their value depends on *the costs necessary for predicting and bringing to market the most costly portion of the supply required,* or the marginal cost.

The above analysis, of course, applies to commodities in the long run. In the short run, prices fluctuate around values according to the relationship of supply and demand; prices rises the as the demand rises and fall as the supply increases.

In concluding this section, it may be pointed out that Mill's sensitivity did not extend to two doctrinal matters of his time: theories of value and monopoly. Ricardian theory of value had been challenged by the Oxford and Dublin economists, yet it remained unchanged in Mill's *Principles*. Instead he asserted … *Happily there is nothing in the laws of value*

[262] Ekelund and Hebert, pp. 176-177.
[263] ibid., p. 176.

which remains for the present or any future writer to clear up; the theory of the subject is complete: the only difficulty to overcome is that of so stating it as to solve by anticipation the chief perplexities which occur in applying it[264].

The Theory of Reciprocal Demand

With his theory of international value, Mill provided an important contribution to the economic theory, a stepping-stone between David Ricardo and Alfred Marshall[265]. Mill endorsed Ricardo's advocacy of free international trade based on the law of comparative costs[266]. But to this law Mill added a law of international values.

Mill showed that the actual barter terms of trade depend not only on domestic costs but also on the pattern of demand. More specifically, the terms of international exchange depend on the strength and elasticity of demand for the product in the foreign country.

Mill extended his deep understanding of the supply and demand into the area of international values. He proceeded to construct a model that included both cost and demand determinants of international values and the terms of trade. He pointed out that the value of an imported good is the value of commodity exported to pay for it. The things, which a nation has available to sell abroad, constitute the means for purchasing goods from other nations. Thus the supply of commodities made available for export could be thought of as the demand for imports. Mill referred to this idea as *reciprocal demand.* He showed this by Abstracting from transport costs and technological changes, Mill built a two-country, two-commodity model[267].

Dynamics of the Economy

In the *Influence of the Progress of Society on Production and Distribution,* Mill forecast increasing production and population, continuing growth of society's mastery over nature, increasing security of

[264] Quoted in Spiegel, p.386; Bhatia, p.160.
[265] Niehans, p. 129.
[266] Bhatia, p. 161.
[267] Quoted in Ekelund and Hebert, pp. 179-183.

person and property, and a growing role for corporation. Improvements in industrial production would be offset by diminishing returns in agriculture and mining as the population continued to grow. He also thought that a falling rate of profit was inevitable because of the increased cost of producing food for a growing population.

Progress of society, Mill wrote, would tend to diminish the minimum acceptable rate of profit. More security, less destruction by war, reduced private and public violence, improvements in education and justice – all these would reduce the risk of investment and thereby reduce the minimum necessary rate of profit. In addition, people would tend to show more forethought and self-control in sacrificing present indulgences for future goals. This would increase the pool of saving, lower interest rates, and promote capital accumulation even though the profit rate was low.

The growth of capital would not cause a glut on the market, in that Say's law would keep the economy operating at full employment; but the rate of profit would decline. The waste and destruction of capital values during crises, improvements in production, the inflow of cheap commodities from abroad and the outflow of capital into colonies and foreign countries would counterbalance this tendency. The final progress would be a stationary state.

As the working classes increase their intelligence, education and love of independence, their good sense would grow correspondingly. Their habits of conduct would then lead to a population that would diminish in relation to capital and employment profit-sharing business and co-operative enterprises operating within a competitive milieu, would further ameliorate conditions. This is preferable, Mill argued, to full-blown socialism, which by deprecating competition would promote monopoly.

Role of Government

A major part of his normative economics concerns the proper role and influence of government. In Part V of his *Principles, On the Influence of Government,* Mill began by distinguishing between the necessary functions of the government and its optional functions. The necessary functions are either inseparable from the idea of government or exercised habitually and without objection by all governments. Other functions are

not universally accepted, and there is room for controversy as to whether or not governments should exercise them[268].

This distinction between necessary and optional functions is important only in so far as it enabled Mill to minimise discussions of the former and concentrate on the latter. Mill's necessary government functions include the power to tax, coin money, and establish a uniform system of weights and measurements; protection against force and fraud; the administration of justice and the enforcement of contracts; the establishment and protection of property rights, including determination of the use of the environment; protection of certain goods and services, such as roads, canals, dams, bridges, harbours, lighthouses, and sanitation[269].

Although Mill was less of a doctrinaire on the matter of government interference, the key limits of the laissez faire principle lies in his recognition that government interference under capitalism *could be required by some great good.* Thus, Mill was able to list several exceptions to the laissez faire doctrine without compromising the basic principle. His exceptions would allow government intervention in the areas of consumer protection, general education, preservation of the environment, selective enforcement of permanent contracts based on future experience, public utility regulation and public charity[270].

In short, Mill recognised, and in some cases enunciated for the first time, the majority of popular exceptions to laissez faire that have become an integral part of modern capitalism. He was very explicit about the caveats the state should employ in instituting such measures, and he would not necessarily approve of all existing amendments to the institutions of capitalism[271].

Remarks on Mill

John Stuart Mill must appear prominently in any intellectual history. His importance was not limited to his being the last great economist of the classical school, - the greatest of the orthodox economists during the two generations between Ricardo and Marshall. His first important book,

[268] Ekelund and Hebert, p.188.
[269] ibid., p. 188.
[270] ibid., pp. 188-189.
[271] ibid., p. 189.

System *of Logic* (1843), established him as a leading logician. The essays he published, including *On Liberty*[272] (1859), *Considerations on Representative Government* (1861), and *The Subjection of Women* (1869), showed him to be an outstanding political scientist, social philosopher, and champion of the democratic way of life. Mill looms large as a man of courage and honestly in his trenchant criticisms of the status quo, his support of reforms that were radical in his day, and his concrete contributions to the discipline of economics. Cynics may scorn his belief in progress through the development of our intellectual and moral faculties, but it cannot be denied that he had a noble vision of the perfectibility of humanity. Mill's warmth, his humanitarianism, and his empathy for the poor and lowly were unusual for a leading theoretician in a science, which had become known for its cold rationality and its sometimes-dismal predictions

[272] This Essay was published in 1859 shortly after the death of Harriet in 1858, and it was dedicated to her memory. The essay puts forth the proposition that the only legitimate reason for interfering with the liberty of an individual are self-protection and the prevention of harm to others. In particular, an individual's own good is not sufficient warrant for curtailing his freedom. Niehans, p. 129.

IX. THE NATIONALIST SCHOOL

9.1 Introduction

The nationalists comprise a group of politico-economic writers of the early nineteenth century, who attacked the individualistic-cosmopolitan, free trade doctrines of the Classicists, and advocated policies designed to build up the productive powers of nations, without direct regard for individual wealth. The Classicists looked at the nation through the eyes of the individual, and regarded its wealth as the sum of individual wealth. The Nationalists saw individuals as dependent upon and subordinate to the power and wellbeing of the whole[273].

As the nineteenth century began, the difficulties of extreme individualism and laissez faire became apparent, not only in theory, but also in dealing with the practical problems of crisis, unemployment poverty, monetary manipulation and war. The underlying assumptions of Classicism had either led to pessimism, or to a futile and unreal optimism[274].

Nationalism was also fostered by inequality among nations, and throve in industrially backward countries which sought to build up their strength, both militarily and economic. In some ways it looks like Mercantilism, however, nationalism rests upon a more idealistic and purposive conception of the state as an organised whole.[275] Thus, it is no wonder that the serious outbreak against the authority of Adam Smith should take place outside Britain, notably Germany.

Germany has been one among the civilised countries to lead the rebellion against political economy. Many German thinkers felt that the economic doctrine of the classical school did not meet the requirements of Germany, and from the earliest years of the nineteenth century her economists took a more *nationalistic* stand. Furthermore, there also developed a characteristic German idealistic philosophy, which considered mind as the only reality. Immanuel Kant attacked empiricism and rationalism, and maintained the power of moral self-determination[276].

[273] Haney, p. 403.
[274] ibid., p.405.
[275] ibid., p.404.
[276] ibid., p. 405.

He argued that man's intuitions of time, space and quantity, etc., come from the spontaneous action of the ego. J. H. Fichte sought to supplement Kant's thought by showing how such intuitions are derived from pure consciousness, stressing the freedom of the will and the moral aspects of human nature.

Thus, it is clear that the development in economics, like other social sciences, is greatly conditioned by the social environment. In Germany, where the tradition of *Romanticism* developed, it is depicted as a kind of ideal, an illusion and mysticism. In social sciences, it reflects an approach in which cultural and religious values manifesting themselves in the *volkgeist* or *the spirit of the nation* are fused into more earthly value-system of the members of society. In other words, it involves recognition of the fact that various *rational* and *irrational* considerations bear upon human activities. While classical economics was being nurtured on principles of individualism and economic rationalism, in Germany a different view was taken of the facts. As opposed to individualism and economic rationalism (or the creation of the *economic man*) the romantic approach lays emphasis on the totality of circumstances.

In Germany this element of conservatism dominated against that of liberty and a revolt for change[277]. As the state was considered as an integral part of society, change was wanted but only under the authority of a powerful state, which would take paternalistic care of the members of society. The change was to take place only for the overall welfare of society and not directed towards individual aggrandisement. To the Germans the state was an integral part of the whole society. It was not just a sum total of individuals, but it had its own life, entity, and authority under which the society evolved along its cultural, economic, and social paths. The state was an eternal being as opposed to the individuals who were short-lived. Therefore, it was a question of realising the needful and dominant role of the state in the evolution of a society in its manifold aspects rather than viewing it as unnecessary appendage.

The nationalist economics show close affinity with *romanticism* and the historical school. Thus, romanticism adopted in economics, emphasised nationalism by highlighting the fact that economic laws are not universal or transcendental, they differ from nation to nation and even within a nation in terms of the stage of its evolution. It insisted that every man has his past

[277] This is significant as being a revolt against most of what the French Revolution stood for. Haney, ibid., p. 405.

and present in the sense of belonging to a cultural tradition, which is the result of a long historical past of the nation. The present depends upon what was inherited from the past. This line of thinking would lead the economists to study the specific characteristics of an economy together with its institutional constraints and the policy prescriptions for its healthy growth.

The principal sources of the philosophy of the Romantic School are the writings of Edmund Burke and Johann Gottlieb Fichte, Johann Wolfgang Goethe and Friedrich Hegel. Among the leading nationalist economists one may mention the Americans Alexander Hamilton, Matthew Carey, Daniel Raymond and the German Friedrich List.

9.2. Edmund Burke (1729-1797)

He was a dominant figure among the British statesmen for many years and is regarded as a thinker of high intellectual calibre whose writings gave philosophical support to the conservative attitudes of his time. His political views are expounded in his celebrated book: *Reflections on the Revolution in France.*

Burke opposed the concept of *natural rights*, which inspired revolutionary thinkers and which did not take into account the moral and spiritual tenets of society. Unlike his predecessors, Burke believed that society was not regarded as merely aggregation of individuals but also was a *complex of habits and loyalties, traditionally recognised authorities and common historical experience.* For him a nation *is not an idea only of local extent and individual momentary aggression; but it is an idea of continuity, which extends in time as well as in numbers and in space.* Hence, the state for Burke was *a partnership between those who are living, dead and those who are to be born.* This romantic temperament of Burke, which reached the Germans through a translation of his found a great response among the German intellectuals of the time.

9.3. Johann Gottlieb Fichte (1762-1814)

Born into a German middle class family, Fichte was given a solid educational preparation. His highly mature writings not only gained him a professorial chair at the University of Jena, but also made him one of the most prominent exponents of German romantic philosophy and

nationalism. His political philosophy, together with that of Edmund Burke, is regarded as a major source of *German Romanticism*. In his *Foundations of Natural Rights*, Fichte reveals that he was in the tradition of John Locke, but like Burke, he did not draw democratic conclusions from the philosophy of *natural law.* The experience of the French Revolution combined with the conditions of contemporary Germany led him to a view of the state, which could well be used by German Romantics.

Fichte described the state as an *organised product of nature* in which each particle had existence only by virtue of its being part of the whole. The state was a special entity independent of the individual members of whom it was composed, a divine expression on earth. From this concept derives the totalitarian view of the state held by Romantics.

In the field of economics, Fichte rejected the concept of *laissez faire* because he thought that power was too unevenly divided. As he perceived the state in a more than utilitarian sense, he felt that the state ought to have the duty *not only to safeguard the property, which each member owned but also to ensure that each member should have the property, which is his contribution to the common labour made his by the natural law.* Fichte opposed Adam Smith's cosmopolitanism and free trade and regarded foreign trade not only as a source of economic dislocation but also as a cause of natural rivalries, which would ultimately culminate in wars.

9.4. Adam Muller (1779-1829)

Muller who was regarded as the apostle of social community, was born into a German Protestant family. This thinker, who before Napoleon humbled Prussia at Jena in 1808 was admirer of the French Revolution and a liberal, changed to become the defender of German conservatism and a major exponent of the *German Romantic School*. Muller applied romanticism to political economy as a reaction to Adam Smith's over-emphasis on individualism.

Romanticism was a *mystical and inchoate movement that emphasised the community of souls and the merging of the individuals into a large whole.* Romantic philosophy held the state in high esteem and regarded it as an organism with a life of its own, whose right was by far superior to individual rights and welfare. This mental attitude dominated German political thinking in contemporary history and ultimately culminated the explosion of nationalism, which the world has witnessed, with the advent of

Nazism and the subsequent devastation of the Second World War. The abnormal love for the *fatherland,* which was deep-seated in the minds of German thinkers who wrote on national themes, led them to believe in the virtue of wars and military conquests. Muller, however, used romanticism as an efficacious antidote to the individualism of the economic classicists.

Under the influence of his patron Friedrich Von Gentz, Muller turned to politics placing himself at the service of Metternich, the Austrian Statesman known for his enmity and oppression of liberals. In 1808-9, Muller produced his celebrated *Elements of statecraft*, which was later used by Nazi ideologists. This book deeply influenced by Burke and Fichte, develops the doctrine of feudal society whose structure is based upon four functional classes or estates: the nobility, clergy, merchant and artisan. His political philosophy reveals a strong opposition to liberal democracy and individualism. In opposition to what he termed *Adam Smith's egoism and materialism*, Muller stressed *altruism and spiritual values.* He accused capitalism and the economic classicism, which supported it by aiming at the disruptive atomisation of society - a state where each was at war with the others. He saw in the capitalist philosophy with its division and mechanisation of labour, which Smith praised so highly, a state of continuous belligerency among the components of society. He regarded society as an organic whole, not congeries of conflicting individuals and considered the state as an organism, the components of which were like cells and therefore could not be thought of outside it.

Muller regarded as absurd the attempt to isolate, even theoretically, wealth-gaining activities from the other aspects of human behaviour or acts, such as expressed by art, religion or the services of the state. For him, all these activities were equally productive and useful. Value is not inherent in material things only; it is derived just from their usefulness to individuals. He believed that not only commodities have value but also *the word of the statesman who would perhaps bring millions of actual money into existence; the words of the pries or of the artist which ennoble the heart or enlarge the imaginative faculty of nations.*

A leading thought in Muller's reaction against Adam Smith is the necessity of abandoning his cosmopolitanism and of founding a national political economy. Believing in the utility of a strong national feeling, he holds that opposition and contest among different countries are desirable. Protection to home industry, and even prohibition of certain exports and imports, are

defended on the ground that they stimulate national feeling and give national character to the wealth of the nation[278].

Yet, the frontal attack that was launched by Muller against economic classicism and industrial capitalism has found an echo in the writings of contemporary critics of the mechanised and materialist civilisations. Much has been said against the spiritual flaws that have resulted from industrial set up of highly industrialised nations and a cry is now being launched for the humanisation of the industrial society.

9.5. Friedrich George List (1789-1846)

This thinker is regarded as the champion of new economic nationalism. Though he was deeply influenced by German Romanticism, List approached the subject of economics with more systematic and sober idea than did Adam Muller. He was born into a German middle-class family in Reutlingen Wurtemberg, and he started earning a living by joining his father's tanning business. However, he left it to join his country's public service[279], in which he made rapid progress. His civil service position promoted him to pursue his University training and to further his self-training. His high erudition enabled him to hold the chair of Economics and Political Science at the University of Tubingen. His academic career however had a short duration for he was expelled because of his liberal views[280].

In 1819, he became leader of the General Association of German Manufacturers and Merchants and the very soul of the movement was to confederate the German states[281]. At this time, Germany was split into several small states linked with one another by a loose federation, and each state imposed a protective tariff of its own. Convinced that each of these states was too small to build alone a self-contained economy, List

[278] Haney, p. 408.
[279] As a representative of Reutlingen to the parliament, [in 1820] among others he favoured a decided reduction in the number of civil service officers, the sale of public domains, and a single direct income tax to meet the expenses of government. This displeased the powers of authority …[so]… he was dismissed from parliament and sentenced to ten months imprisonment. ibid., p. 411.
[280] He went to Pennsylvania in the 1820s and was a success at coal mining and short-line railroading. His experience and observation led him to believe that industrially underdeveloped countries needed protective tariffs. Staley, p. 200.
[281] Ekelund and Hebert, p. 241.

raised his voice loudly against these separately imposed tariffs. The tariffs hindered the free movement of goods from one member country of the federation to another, and thus he strongly advocated for a custom's union (*Zollverein)* to which all were to adhere. The new system was to be protected by a moderate customs tariff to be imposed on all industrial products of foreign source. This, he believed, would permit German manufacturing industries (most of which were in the infant stages), protected, as they were, to prosper. This stand however clashed with the interests of some of the absolute rulers and cost him not only expulsion from the university but also a ten-month imprisonment. But, before serving his full sentence he was permitted to migrate to the United States of America.

He lived with his family in the USA from 1825 to 1832, where he joined and greatly influenced the American movement for protective dues. He returned to Germany not as a German subject but as a naturalised American citizen and Consul at Leipzig. After his repatriation he worked on his old idea with more consistency and, as a result published in 1848 his celebrated book: *The National System of Political Economy.*

List, unlike his friend Adam Muller, did not launch a frontal attack on economic classicism and industrial capitalism. While Muller expressed his bitter aversion to modern industry inasmuch as he saw in it a vicious tendency of division of labour and of factories, which were nothing but barracks, and the slavery to which it subjected every one. List accepted manufacturing industry and regarded it as an effective means of national development. His hostility to economic classicism was not directed towards its theories *per se* but was due to the fact that the new system was evolved to serve the English social set-up to which it was well suited, and also countries in similar conditions. This was the reason for his advocating a protective tariff on English and other foreign products. A protective tariff, he argued, would well serve the purpose of contemporary Germany if flourishing economic progress were to be secured. He believed that a manufacturing industry was an indispensable part of well-balanced national productive equipment and that both industry and agriculture were essential to the strength of the state. Industry, he argued, led to agricultural improvement and to the development of art and science which agricultural alone could not attain. Accordingly, nations could be grouped in accordance with the degree of civilisation they had attained. Thus, there were the savage, the pastoral, the manufacturing and commercial states. Though it was not possible for all states to reach the highest stage of development, Germany, which

possessed the necessary material and human resources, could, he believed, reach that stage. To do this, however, List believed that the state should play an important role in regulating the national economy. However, he was not fundamentally averse to the concept of *laissez faire* and he would accept its adoption if the necessary social, political and legal arrangements of democratic government were sufficiently developed. He would also accept free trade among equally developed nations.

List's work: *The National System of Political Economy* can be summed up in three main ideas woven together to form a cohesive system. These are the development of productive forces; inequality in the productive capacities of nations, and different stages in the national and cultural growth of nations.

The development of productive forces **-** A community's power to produce wealth was not merely a matter of individual self-seeking, but the existence within the community of adequate organic and cultural conditions favourable to production-conditions, which he termed productive forces. These productive forces include a desirable variety of natural resources, science and art, good laws, a high level of intelligence, the maintenance of order, the existence of morals and harmony and a balance of the various industries and occupations themselves. List cited, as an illustration of some great productive forces: the Christian religion, monogamy, improved transportation, freedom of conscience, publicity of legal proceedings and parliamentary legislation.
Inequality in the productive capacities of nations **-** His second important point is his observation of the striking inequality of the capacity to produce, a condition, which prevailed among the world great nations, phenomena as obvious when he wrote as it is today. This observation led him to reach a conclusion with regard to free trade, which is quite different from that of Adam Smith. Free trade, he argued, would considerably benefit an economically strong nation, such as England, but would certainly damage new nations as the United States of American and Germany whose infant industries could in no way compete with the products of the highly developed British industries, unless protected by adequate protective tariffs. The prosperity of coalmines, he cited as examples, needed iron smelting near at hand; the latter was of no use without a rolling mill, which needed a market in the form of factories to make machines, and railroad and building construction. Not one of these enterprises could make headway without each of the others; each is either complementary of supplementary to the other. Thus, a more highly

developed competitive nation could prevent the growth of the whole complex in a new region by underselling any of its essential factors. Unless properly protected, therefore, a weak nation cannot promote the growth of the necessary infrastructures. He believed, however, that free trade would operate to the mutual interests of all if the competing nations were on the same economic level.

Different stages of national and cultural growth – List detailed five stages of development from the history. These stages of development are: barbaric; pastoral; agricultural; agricultural-manufacturing; and agricultural-manufacturing-commercial. Thus, List concluded, a policy, adapted to one stage of development would not be adequate for another. By his classification and testimony, only Great Britain had attained the final stage of economic development.[282]

9.6. Henry C. Carey (1793 – 1879)

This American economist may be said to have a dual system of thought; or he may be called philosophically inconsistent[283]. In some respects he differed from Classical economists while in some essential parts he agreed with them. He accepted a concept of economics based upon the price system, and he presented a theory of value of the same general type as the Classical theories. He appeared to have had a concept of the problem of distribution, which enabled him to rely upon the working of social laws[284].

Carey held Smith in considerable estimation while condemning some of his English followers. In his *Principles of Political Economy* [published in three volumes between 1837 and 1840], he indicates three principal theories covering protection, rent and population. He was opposed to the Ricardian theory of rent[285]. Carey maintained, in his *The Past, the Present and the Future* (1848), that experience shows that at first men take up poor soils, because they are light and sandy and easier to cultivate. Men begin to cultivate the hills, and when the poorest land is exhausted and

[282] Ekelund and Hebert, pp. 241-242.
[283].He possessed much originality, but lacked a scientific training. His work is unsystematic and not without glaring inconsistencies. Haney, pp. 315-328.
[284] ibid., p. 315.
[285] In his *Principles of Social Sciences,* Carey claimed that the Ricardian theory not only lacked universal applicability, it also was universally false. Bhatia, p. 183.

numbers and knowledge have increased they work down toward the rivers and make use of the rich valleys. The last settlers therefore, receive the best land. Labour becomes continually more productive, wealth increases, and man progresses. Carey seeks the aid of history in the development of his theories, but apparently his knowledge appears to have been limited. Nevertheless, the three principal theories in his system are protection, rent and population[286].

In his views of population, he holds Malthus to be wrong. The arguments are: First, increase of population is God given instruction and there can be nothing wrong in that. The second argument is deduced from the harmonious laws of nature. The third argument is that the increases in numbers means increase of wealth. Furthermore, Carey argued that it is absurd to suppose that man alone increases in geometric ratio. The lower animals, which furnish him with food, increase as rapidly[287].

9.7. Alexander Hamilton (1757-1804)

Alexander Hamilton was a lawyer and statesman – one of the greatest statesmen produced by America – and his views are to be drawn chiefly from his state papers on finance[288]. During the years 1790 and 1791 he discussed in a lucid, temperate, and weighty manner the economic questions, which confronted the nation: the public debt, money, banks, protection of manufactures.

His *Report on Manufactures* (1791) was written to refute the arguments for free trade in the *Wealth of Nations,* and it led to the passage of an act imposing import duties and encouraging of industries. Carey is credited with popularising the need for protection and he used his membership in the Philadelphia Society for the Promotion of National Industry to do that on a much larger scale.

Hamilton favoured bimetallism on ground of expediency; showed the advantages of using public credit and of a national bank; and forcefully stated the grounds for government intervention to encourage industry, as opposed o the general *laissez faire* position. In denying the argument that labour is more productive in agriculture than manufacturing, he clearly

[286] Haney, pp. 322-323.
[287] ibid., pp.321-325.
[288] Haney, p. 316.

suggests the idea that land is but a form of capital, an idea characteristic of the *American School*.

Other characteristic features are the emphasis he laid upon building up domestic manufactures in order to develop a home market for agricultural produce[289] and a note of optimism.

9.8 Daniel Raymond (1786 – 1849)

Raymond published his *Political Economy* in 1820, provided a basis for an active public policy of promoting economic development by distinguishing individual and national wealth and making the latter his chief concern.

The book shows several points of similarity to Hamilton's ideas, and classes its author as a forerunner of Carey. Like Carey, Raymond was on many points opposed to the cosmopolitan of the classical School. He favoured a protective tariff, and argued at length for internal freedom of trade while demanding restrictions on imports. In this connection, he shows the American School's characteristic animosity toward England. It was not for old Europe, burdened with chronic evils, to develop the true political economy, he maintained, but for vigorous young America[290]. In his plea for protective tariffs Raymond made use of both of the infant industry and of the employment argument, speaking explicitly of *full employment*[291].

[289] Hamilton brought forth seven arguments in favour of manufactures: division of labour; extension of use of machinery, additional employment to those classes of the community not ordinarily engaged in business – women, children and others; promotion of emigration from foreign countries; greater scope for diversity of talents and dispositions, which discriminate men from each other; more ample and varied fields of enterprise; and the creating, in some instances, a new, and securing, in all, a more certain and steady demand for the surplus produce of the soil. Haney, p. 317.
[290] ibid., pp. 317-318
[291] Spiegel, p. 362.

X. THE RISE OF SOCIALISM

10.1 Introduction

The social thinkers of the eighteenth and nineteenth centuries, as a whole, upheld the *liberty* and *dignity* of man and the *supremacy* of the natural law in a way that supported the emerging economic order capitalism. This was not without reaction against the early development of industrialism.

To thinkers like Adam Smith, David Ricardo, and their disciples, *capitalism* meant an undreamed expansion of production, increase of wealth and economic intercourse between nations, together with all the cultural benefits involved. In addition, capitalism, to them, meant liberalism in politics and the destruction of oppressive regulations and obscurantism reaction. This optimism, however, had undergone a sad decay in a doctrine such as that of Malthus. In his theory, known as the *iron law wages*. Malthus held that labour could never for long receive more than a mere subsistence wage and might even fall below that, no matter how much the sum of wealth might be increased - a belief also held by Ricardo himself and other classical economists of the time. In fact, it seemed to the workers of the time that they were being called upon to bear the cost of this revolution. To them, early capitalism meant utter pauperism, unemployment, or at best, hard labour in factories for themselves, their wives, and children. They thought that long working-hours, dangerous and unsanitary working conditions, and oppressive supervision by capitalists were their common lots. The conditions of the time were such that workers and capitalists were antagonists; wide disparity of income was accepted as natural and unavoidable; and everything suggested that there was no hope for social and economic equality.

The precarious social set up of the time gave rise to two currents of thought. One was the reaction presented by the *German Romantic School* against capitalism and the classical economic doctrines that upheld it. The other current of thought was embodied in the *Socialist Movement,* which began with the writings of the French *and English Utopian Socialists* of the early eighteenth century and which culminated in the revolutionary socio-economic thoughts of *Marxism.*

10.2 The Visions of the Utopian Socialists[292]

As a reaction against the precarious conditions of the masses in the early stage of industrialism, an old tradition - that is, the belief in the *natural law* - appeared in a new garb, with all its vehemence, to men of good will, though it ran counter to the prevailing current of history. This appeal emphasised the social aspects of the supposed *natural order,* i.e. the readiness of men to co-operate, the perfectibility of human nature and the desire for equality, not only political but also social and economic. This type of philosophy, although often condemned as materialistic, laid no more stress on material goods than the doctrine of the individualist. Its leading exponents were concerned with economic arrangements only as an instrument to open the way for what they regarded as the *natural nobility* in all men, which they believed had been eradicated from mankind by *maltreatment, misery and an incorrect type of education.*

The roots of egalitarianism can be traced as far back as the *enlightenment.* The belief in the *equality of men* and the demand for it were sown in ancient Greece; it had been watered down by earlier religious exhortations and began to germinate in the early eighteenth Century. Attempts were made to apply the social and economic equality of men in the past. Some events of the English Puritan Revolution of eighteenth century afford a good illustration of the appeal to egalitarianism in history. The Puritan *levellers* tried to swing the balance of power not only from the king to the *commoners*, but further, to the property-less workers. A distinguished person of this revolution, Gerald Winstanley, leader of Riggers, contended that property had been held in common until the *Norman Conquest* and appealed to Cromwell to restore free land.

The word *socialism* usually conjures up a number of meanings: public ownership of economic enterprise, subjugation of individual freedom, elimination of private property, conscious direction of economic activity, and so on. In practice, socialism is rarely the clear-cut alternative to capitalism it is often held out to be. Every capitalist economy today possesses some socialist elements or institutions and vice versa. Moreover, many past writers who are today called “socialist” can be delineated from one another on the basis of significant philosophical differences. There is, however, sufficient ground among such writers to

[292] The title was taken from Robert L. Heilbroner, *The Worldly Philosophers: The Lives and Ideas of the Great Economic Thinkers,* 6th ed., London: Clays Ltd., 1991, pp. 105-135.

distinguish them from the classical economists. This is particularly true of that group of writers often referred to as the *utopian socialists*. The utopians regarded capitalism as irrational, inhumane and unjust. They repudiated the idea of laissez faire and the doctrine of harmony of interests. They were all optimistic concerning the perfectibility of man and the social order through the proper construction of man's social environment.

The Enlightenment and the French Revolution further elaborated the communistic ideas even further. Jean Jacques Rousseau believed that private properly had not existed in the *state of nature* and its introduction to society was a social abuse. These ideas echoed loudly among the Paris mob during the French Revolution. The French Revolution, however, though it was a mass movement and proclaimed *liberty, fraternity and equality*, turned out to be a strong weapon of the *wealthy bourgeoisie* against the landed aristocracy, and did almost nothing to alleviate the plight of the *common people.*

As elsewhere in Europe, the growth of early industrialism in France was accompanied by *unemployment*, *long working-hours, and undesirable working conditions, starvation wages and the decline of agriculture*. The resulting disillusionment created a favourable atmosphere for the apostles of economic equality.

In the following paragraphs we present a brief sketch of some of the *utopian socialists* who have made a name for themselves in their attempts to change the world as they saw fit.

Francois Emily Babeuf (1760-1797)

This dreamer was a product of the French Revolution and a strong supporter of the *Reign of Terror*. As a propagator of extreme egalitarian ideas, he plotted to overthrow the *Directory*[293]. He called himself Caius

[293] It refers to the government of France in the difficult years between the Jacobin dictatorship and the Consulate. It was composed of two legislative houses, a council of five hundred and Council of Ancients, and an executive [elected by the councils] of five Directors. It was dominated by moderates and sought to stabilize the country by overcoming the economic and financial problems at home and ending the war abroad. In 1796 it introduced measures to combat inflation and the monetary crisis, but popular distress increased and the opposition grew as the Jacobins reassembled. Although the conspiracy led by Babeuf was crushed it persuaded the Directory to seek

G*racchus, tribune of the people,* after the idealistic leader of the Roman proletariat. The *conspiracy of equals* was exposed at the eve of its implementation, and Babeuf, together with his follow-conspirators, was condemned to the Guillotine. Secrets societies perpetuated his ideas, known as Babouvism.

His socio-politico-economic concepts[294] can be summed up as follows. He believed that *nature has given every one an equal right in the enjoyment of all goods.* His programme was to call for an immediate national ownership of all large business enterprises and eventual nationalisation of all private property by abolishing inheritance. Production and distribution were to be directed by an elected government. No one could have political rights who did not *do* useful work, and teaching contrary to the tenets of the regime was for bidden. Food and cloth were to be exactly the same for all, except for differences according to age and sex. Children were to be taken from their parents and taught the ways of the new society.

Etienne Cabet (1788-1856)

Babeuf's rigorous doctrine of equality was reflected in Etienne Cabet's book: *The Voyage to Icaria*. Cabet was a firm believer in *communal life* and he was inclined to adopt peaceful methods in the setting up of his much-coveted communistic society rather than resort to conspiracy and violent means.

Etienne Cabet studied law and became, for a while, a public official. He was elected to the house of deputies in 1831 but his bitter attacks on government resulted in his conviction for treason. He escaped prison and lived in exile in Britain.

His socio-political views are reflected in his novel *L'Icaria,* which envisaged a technical dictatorship where uniformity of every kind

support from the royalists. In the election year, supported by Napoleon, it decided to resort to force. The second Directory introduced authoritarian domestic policy, however as economic difficulties in agriculture and industry led to renewed opposition, the Directors turned to Napoleon, who took the opportunity to seize power. Oxford Paperback Encyclopaedia, 1998.

[294] When he moved to Paris in 1794 he had started to publish the *Journal de la Liberte de la Presse,* in which he argued that the Revolution should go further than establishing political equality.

prevailed. In Icaria everything confirms to plan such that the streets are straight and each block contains exactly fifteen identical houses, supplied with the most modern sanitary equipment. The sidewalks are covered with glass roofs, and dust-collecting machines sweep the streets. In *Icaria*, everything is owned by the state, which provides equal distribution of all products among the citizens. All people dress alike, though the choice of the colour of dresses is left to personal tastes. Newspapers are not allowed and books are censored by the state before publication. As a child of the French Revolution, he even saw to it that the whole programme was laid out in accordance with the decimal system.

Cabet believed that the *regime*, which he dreamt of, could be made a reality through legislative measures and within fifty years. However, when he realised that it was impossible to actualise his imaginary society in France, he emigrated to the United States of America. In 1848 he founded an Icarian community on the Red River, in Texas, which due to the prevalence of yellow fever, was forced to move to an old Mormon town of Nauvoo. Unfortunately, serious dissentions arose in 1856 and Cabet was not re-elected president[295] of Nauvoo. He died soon after in St. Louis. Most of the Icarians then moved nears Corning, Iowa, to lands they purchased, where branch communities survived until 1898.

Saint-Simon (1760-1825)

Claude Henrie de Rouvroy Comte de Saint-Simon was both an eccentric and a prophet[296]. He was notable for his breadth of view and his creative suggestiveness[297]. Born into the French nobility, he claimed a direct descent from Charlemagne, and thus he did not hold any modest view of his own importance. Despite his eccentricity, he frequently revealed keen analytical insight into social and economic processes. He succeeded in founding a school of followers, and he influenced a number of thinkers including Karl Marx and John Stuart Mill[298].

[295] Details are available at the International Institute of Social History, the Netherlands. See also: *The Columbia Encyclopaedia*, 5th edition, Columbia: Columbia University Press, 1995.
[296] Ekelund and Hebert, p.235.
[297] Haney, p. 427.
[298] Ekelund and Hebert, p. 235.

Thus, while suggesting modifications, he is not so clearly opposed to private property[299], and seems to allow it in the form of capital when that is in the form of what he calls investment worthy of compensation. Neither does he have in mind the conflict between labour and capital, but a more general one between the workers the idle. He said that society should be reorganised in such a way that all must work. To ameliorate the physical and moral condition of all members, the basic needs considered are regular work and general education or knowledge.[300] Thus, unlike some of his other *utopian* compatriots, he stood not for *uniformity* but for equality of opportunity for all.

The heart of Saint-Simon's idea was to direct the labour of the nation so as to ameliorate the physical and moral conditions of all its members. The chief needs he considered to be regular work and general education or knowledge. To this end, he advocated a broad industrialisation[301]. Since the industrial class achieved the Revolution, he wrote, upon this class depended freedom[302]. Three classes would come into existence: savants, artists and those engaged in industrial pursuits.

He volunteered in the American War of Independence and was an active supporter of the French Revolution. He devoted his entire time and energy to a long-lasting struggle for the triumph of his ideals, and, in spite of hard privation, sacrifice and relentless struggle, which he bravely endured, he succeeded in giving a concrete shape to his ideas which appeared in his most important work: *Nouveau Christianisme* published in 1825, and which he hoped would usher in a golden age. In this book, Saint-Simon argued, that men were in need of a new *spiritual authority*, which would adopt the role-played by the Church under the feudal system. To destroy the *old regime* alone and to abandon society to an anarchic individualism, he contended was not enough; a new order should be established on a scientific and industrial basis. The new order must be

[299] His followers went further than Saint-Simon in attacking private property. As the idle class must go and all are to work, capitalists as such cannot exist. Haney, p. 428.
[300] ibid., p. 427.
[301] Saint-Simon was…a tireless advocate of industrial development, full production, and the primacy of economics over politics. To place science and technology in the service of the state so reorganized as to achieve these goals, he assigned, in an early version of his proposals, commanding position to scientists and engineers. In later versions the emphasis shifted to bankers and businessmen, who as members of a sort of planning board, were to constitute a managerial elite and assume the direction of the economy, transforming the anarchy of production into an organisation of production. Spiegel, p. 447.
[302] Haney, p. 427.

directed under a new religion. This new religion, which was vaguely theistic in character, was to possess an elaborate organisation of savants and priests. He also advocated that war should be abolished and Europe must be united under a single parliament the membership of which was open to the wise and the just. The morality of his *New Christianity* was to be based on the principle that *men ought to regard each other as brothers.*

In Saint-Simon's *regime*, social industry was to take the place of private enterprises, while consumption of goods was to be left in private hands. The delicate problem of the distribution of products, which was to be based upon the policy of *equal pay for equal service*, was to be administered by public officials. Further, the regime envisaged no room at all for any idler. The new order, Saint-Simon contended, was to substitute the old without violence and confiscation.

His ardent appeal to reason, which was quite effective, gained for his *new order* a good number of proselytes among the intellectuals and scientists of his day. Eminent among his followers was the philosopher August Comte and Ferdinand de Lesseps, the celebrated designer and builder of the Suez Canal.

Charles Fourier (1772-1837)

Charles Fourier aspired to change human societies to a better system by practical example rather than by preaching. Unlike Saint-Simon he advocated decentralisation in place of central planning; instead of industrialisation a movement back to the land; instead of managerial direction the spontaneous self-assertion of individuals. Saint–Simon worshipped production and work, idols that Fourier refused to revere unless they had qualities gratifying certain innate propensities in men[303].

Fourier attracted much attention from his contemporaries, but has had little influence on subsequent thought. Like those thinkers of the pre-Revolutionary epoch, he believed that nature was altogether good and that evil was the result of human control and influence. He wanted to organise society in a manner that would be conducive to social harmony and at the same time permit gratification of fundamental psychological needs

[303] Spiegel, p. 448.

arising from immutable nature of man and stifled in the commercial society of his time[304].

Two events which he witnessed in his childhood and which deeply impressed his sensitive and highly humanitarian nature seem to have marked the turning point of his life. One of these events was the punishment inflicted upon him by his own father, a merchant, for telling a customer the truth about a product. The other one when he was ordered to throw rice overboard from a ship because the owner, speculating on higher prices during a famine, had kept it until it spoiled. Such corruption of the commercial world convinced him all the more to fight against the existing social structure and to establish a communal life, which was to based on honesty, love and brotherhood.

Fourier believed that the establishment of co-operative associations or colonies of people, *phalanxes*, could demonstrate his ideal concept of communal life. Each *phalanx* was to be a colony of 1800[305] inhabitants who would share labour wealth and housing. Each member of the colony was to be assigned the task of sustaining the group[306] according to personal taste and thus through the joy of work for the common good, combined with efficient management, output would be increased to such an extent as to permit the members to retire in comfort at the age of twenty-eight years.

Work was to be further divested of its character as a burden or duty by the guarantee of a minimum income to each member of the *phalanx*. Fourier, who always favoured diversity and variety, had no objection to a disparity of incomes in excess of the minimum. These would indeed differ, reflecting the individual's talents and skills and the amount of his investment in the community. A levelling tendency for investment income was, however, introduced by the proviso that the rate of return on investments was to decline with their size, the equivalent of a progressive tax on income from wealth[307].

Fourier was a fantastic dreamer. He dreamt that the world was about to enter a *millennium* in which whales would pull ships, lions would draw carriages and seawater would be drinkable. Of course, this sort of

[304] ibid., p. 449.
[305] Haney, p. 430.
[306] Each phalanx was to be provided with 400 acres of land that would be worked out jointly and this would make it self-sufficient. Bhatia, p. 268.
[307] Spiegel, p. 449.

thinking or reverie might have been intended as symbolism or, perhaps, as publicity for his concept of communal life, but it certainly reflects his conviction of the goodness of human nature. In fact, he was convinced that somebody would offer to finance his *phalansterian* project and, he waited in vain in his abode every noon for twelve consecutive years for this someone to appear. Though as a thinker he had little influence on posterity, his proposals obtained a wider approval after his death. A few *phalansteries* were tried in France and in the United States of America, where some pre-civil-war reformers such as Albert Bristane, Horace Greeley and Charles A. Dana, revolted by the spirit of private gain and exploitation, which characterised the newly pledged industrialism, established some colonies after the model of Fourier. The colony of Farm Brook was the most important of a number of colonies tried in the U.S.A. Though some of these colonies endured for a certain length of time, none succeeded in producing the desired results.

Louis Blanc (1811-1882)

Jean Joseph Louis Blanc was the son of an Inspector General of Finance. He was educated in Paris and, at an early age, became a prominent figure in the socialist movement of France. He is regarded as the father state socialism[308] because he put the burden of reform upon the state. He set his ideas in his *Organisation de travail* first published in 1841[309]. The central point in his thought is a desire for a broad and perfect development of each man's personality. Proceeding from the idea of the brotherhood of man, he advocated payment not according to service or productivity, but according to needs and wants. Thus, he postulated the principle of *from each according to his ability, to each according to his needs.* His system, therefore, is not based upon a demand for the whole produce of labour but upon the more philanthropic idea of a right to subsistence [*droit á' la vie*][310]. He called for the recognition of the right to work, and proposed to implement these principles by means of *national workshops*, producer cooperatives, which would be established with the financial assistance of the government and would in time take the place of competitive private enterprise[311].

[308] Bhatia, p. 269.
[309] There were considerable additions to a fifth edition of the book that appeared in 1850. Haney, p. 433.
[310] ibid., p. 433.
[311] Spiegel, p. 446.

The Saint-Simonians of the 1830s[312] heavily influenced Blanc[313]. Though he was more practical than the socialist dreamers of his epoch in that he directly appealed to the workers, and sought the immediate intervention of the state to improve their lots, his schemes were characterised by a good deal of vagueness and sentimentalism.

Pierre-Joseph Proudhon (1809-1865)

Son of a small brewer, Pierre-Joseph Proudhon[314] spent his early years in an environment of small peasant proprietors. He became a printer for a while and his unquenchable thirst for knowledge made him dedicate his time entirely to continuous reading and study of the social problems of his times. From an early age he was interested in social problems and became the leading anarchist of his days. He was greatly influenced by the writings of the political philosophers of the period after the French Revolution, particularly by Fourier. The latter's opposition to centralisation and compulsion by the government made him a forerunner of the anarchists, who proposed to abolish organised government all together. In both these respects – voluntarism and transition to anarchism – Fourier's position resembled that of Proudhon[315].

Proudhon was in fact the first social reformer to call himself an anarchist[316]. He cherished the family and the neighbourly ties within the local community but beyond these limits he had no use for authority and condemned coercion in all forms, be it practised by the government or by associations of the Fourierist type. He thus came to reject representative

[312] Though during the Revolution of 1848 Blanc became a director of a commission of labour, his plans did not come into fruition.
[313] Blanc was not the most original of the early socialists, but he is notable for being the first to make the connection between politics and social reform. Haney, p. 433.
[314] Haney notes that with Proudhon one comes to a thoroughly proletarian socialism, and the beginning of one line of anarchism. Indeed one finds in his thought much that foreshadows the doctrines of the more scientific socialism taught by Marx and Engels. Haney, p. 434.
[315] Spiegel, p. 450.
[316] He is considered a socialist, although he was equally as vehement in his criticism of socialism he knew as in his criticism of capitalism. The two most distinguishing features of his thoughts include a desire to remove all authority and an almost medieval concern for economic justice in exchange. These two characteristics have been combined in the designation of Proudhon as a scholastic anarchist. Ekelund and Hebert, p. 247.

democracy as well as authoritarian socialism and communism and expressed disapproval of a revolution contrived by radical schemers and, indeed, of any violent upheaval launched by proletariat, an instrument of social change in which he refused to place much confidence. On the positive side, he espoused a loosely knit *federalism* among local and regional communities and a system of *mutualism,* which called for reciprocal rights and duties, grounded not in the compulsion of law but freely entered contractual agreements[317].

Proudhon's belief in the concept *that contradiction is the eternal principle of human affairs* certainly bears traces of the ideological influence that had a strong impact on his mind, that is, concept of *antinomy* (contradiction in a law or between two laws) held by great German Philosopher Emmanuel Kent, of the eighteenth Century and by the *thesis and antithesis* of Friedrich Hegel whose doctrine dominated the German philosophy of the time. Proudhon's *philosophical anarchy* is regarded as one of the main inspirers of the syndicalist and anarchist doctrine of later generations.

Though Proudhon wrote widely on economics, his role as a political theorist has been more important than that of an economist. His principal views in the political and economic fields are embodied in his major and famous works. Proudhon centred his attack upon property rights. Property, as distinguished from possession, he said, was robbery; thus property-owners are thieves. He even objected to common property in a communistic state and in this he foreshadows the split between socialism and anarchism[318].

He said that occupation justifies private property, turning his attention to land. Likewise, as a firm believer in the equality of men, he did not support private property in business, also. The enunciation of his famous formula: *property is theft* not only expresses his deep-rooted enmity of the existing order of capitalism, particularly the unearned rental and interest income of certain property owners[319], but also hatred against the state, which he considered as the defender of private property.

A notable feature of Proudhon's thought is its emphasis of the collective or social character of modern production. Neither labour, nor land, nor

[317] Spiegel., p. 450.
[318] Haney, p. 434.
[319] Spiegel, p. 451.

capital is productive alone; production results from their cooperation. All production being necessarily collective, the labourer is entitled to a share in the product. All accumulated capital being social property, no one can be its exclusive proprietor[320].

Simonde De Sismondi (1773-1842)[321]

Originating from an Italian aristocratic stock, Jean Charles Leonard Simonde de Sismondi was trained as a historian, and he acquired practical experience in business and finance in France while he was very young. Later on, Sismondi went to Italy, where he settled and devoted his life to scholarship and writing. Though he wrote widely on economics his fame, as a writer, rests chiefly on his work in history. His economic ideas are contained in his two books *De la richesse commerciale; ou principe d'économie politique, appliqués a la legislation du commerce* and *Nouveaux principes d'économic politique ou de la richesse dans ses rapports avec la population* published in 1803 and 1819, respectively.

In contrast to the *utopian socialists* of the time, he stands eminent among the economic protestants of *classicism* in the early period of the eighteenth century[322]. This thinker, whose approach to the study of economics ranks with the methods of the *Romantic School* rather than with those of *socialists*[323], extolled human values and well being, heralding reform.

He became one of the first and foremost critics of the classical economic theory and method in the nineteenth century. In so doing, he laid much

[320] Haney, p. 437.
[321] Sismondi was an economist and a historian but not a socialist. Nonetheless, many of his ideas influenced Karl Marx. Burtt, p. 166.
[322] There has been divergence of effect produced in different minds by the downfall of old order following the French Revolution. On the one hand, the classical economists welcomed the end of the Mercantilist regimentation and demanded a policy of laissez faire. They dwelt upon individual rights and the motivation to production which individual initiative supplies, holding that self-interest leads to sufficient cooperation among individuals. On the other hand, others came to demand the establishment of a new order to replace the old. They saw irreducible clashes of interest and chaos in laissez faire. They saw the individual as a person seeking protection. Sismondi fell under the second category. ibid., p. 390.
[323] He was not a socialist but had a romantic yearning for the simple and personal type of economic relationships characteristic of the rural economy of bygone days. Spiegel, p. 305.

ground-work for the method of analysis later advanced by the German historical school.[324] His disagreement with the classical economics was based less on theoretical than on its method, aims, and conclusions. Sismondi viewed economics as a science of government, thus he was willing to replace the government by industrial administration. As a moral science, the physical wellbeing of man, insofar as it can be the work of his government, is the object of political economy. A science that concerns itself solely with the means of increasing wealth without studying the purpose of such wealth was, in Sismondi's view a *false science*[325].

He rejected *classicism* because it implied an optimism and a belief in a non-existent harmony and a self-balancing of the capitalist system. Sismondi accused the capitalist system of failing to bring about *an increase in the well being equivalent to the increased expansion of the productive forces*[326]. He asserted that the aim of economies should be the achievement of human well being not the accumulation of material wealth alone, as classical economics wanted it to be. He rejects Smith's concept that the individual, in seeking his own interest, promotes social benefit, and he opposed the principle of *laissez faire* because he regarded it as inconsistent with the general well being. He was not against private property nor did he sanction the concept of complete equality of income, but he condemned the concentration of wealth in the hands of a few people on the one hand, and the extreme poverty of the masses, on the other. This state of things, he believed, was attributable to *laissez-faire* policy. On the contrary, he argued, the state should not remain as a spectator, but should intervene to protect human values and well being.

In his first book he accepts not only the theoretical structure of Adam Smith's work but also the political philosophy upon which Smithian economics rests[327]. In his second book, while still adhering to some of the main doctrines of Adam Smith and the classical school, he draws radically different conclusions, and places the emphasis upon new matters[328]. Here, Sismondi indicates that he is well aware of the break

[324] ibid, p. 238.
[325] ibid., p. 239.
[326] Sismondi, was a reformer and he believed that enjoyment or happiness is the sole end of accumulation and in it lies the true wealth of the nation. He criticised the current emphasis on production calling Classical economics -chrematistique- money making science. Haney, p. 392.
[327] Haney, p. 391.
[328] ibid., p. 391.

with the past, which his thought represents. He refers to his work as an attack against the orthodoxy, and he became an early critic of industrial capitalism as it emerged in England. That the faults of the new order impressed him more than they did others reflects the greater detachment of this foreign observer, who visited England on several occasions and noticed changes not readily apparent to a permanent resident[329].

Sismondi's straightforward advocacy of economic interventionism[330] and his policy proposals are thoroughly modern, and the eventual adoption of many of them in Western Europe and North America has gone a long way toward stabilising the economy, breaking down the barriers between classes, instilling the working people with the middle class mentality, and making them accept an economic order in which they have acquired a stake[331]. They now tend to be taken for granted in the modern welfare state, but at the time he presented them they were new and radical. After all, it was Sismondi, profoundly disturbed by what he considered the ravages of the factory system, who spoke of the existence of two social classes, the rich and the poor, or the capitalists and the workers, who were to him at constant conflict with one another because their interests were opposed[332].

Inasmuch as it would lead to wrong conclusions, Sismondi strongly criticised the deductive logic of the classical school as the method of approach to the study of economics. The abstract hypothesis of the deductive method, he held, need to be tested by studies of concrete facts. As an alternative he suggested the fertile method of *historical approach*, that is, the test of human experience.

Sismondi made two specific observations regarding economic problems that have become a major concern of modern economics today. Though his analysis and the remedy he suggested are questionable, his attempts to tackle the problem are regarded as a great deal ahead of their time[333] and his influence in this regard, is much more extensive than that of his contemporary economists or his classicist predecessors. The first of these observations was that rapid introduction of machinery to the productive

[329] Spiegel, p. 303.
[330] Sismondi recognises a conflict between public and private interests, and so logically calls upon the state to interfere first to adjust production to revenue or demand, and secondly to apply certain particular remedies directly. Haney, p. 399.
[331] Spiegel, p. 304.
[332] ibid., p. 304.
[333] ibid., p. 306.

process leads to technological *unemployment and pauperism,* as it actually did when he wrote. To remedy this, he advanced a dubious theory; *limitation of invention,* so that the productive process could be slackened. The other observation relates to the obvious fact that a severe recurring crisis of unemployment beset the new order. This he wrongly attributed to *overproduction* in the sense that the increased output of a new year could not be purchased with the income of the preceding year.

Robert Owen (1771-1858)

The son of a prosperous farmer and merchant, Robert Owen was born in North Wales in 1771. He left school at the age of only nine years to continue self-education through reading. At the age of nineteen, after borrowing some money from his father, he set up his own business in cotton spinning and became a successful manufacturer[334]. He was the first British textile-mill owner to use American long-staple cotton. Before reaching the age of thirty, he owned the New Lanark mills near Glasgow in which two thousand workers were employed. His success as an industrialist was due to his outstanding capacity as a manager; to his employment of the latest machinery and method; and to the efficiency obtained by the introduction of improvements in the working conditions in his mills.

His career shows three well-marked phases: an early phase from 1799-1824 when he was a respectable owner of a new type of cotton mill in Lanark, Scotland, accompanied by cheap housing for his workers and a school for their children, and struggled to convince the rich and the powerful of the wisdom and practicality of his plans for a new social order; a phase of unsuccessful community building in Indiana, USA, which lasted from 1824-29; and from 1829 onwards, when he was increasingly drawn into British working-class politics, culminating in the formation of the Grand National Consolidated Trades Union in 1833, the first attempt anywhere in the world to form a national federation of trade unions. When this failed within a year, Owen went back to community experiments, in Britain this time. The Rochdale cooperative movement, which flourished in Britain in the 1840s, was undoubtedly inspired by

[334] He was somewhat more practical than Saint–Simon and Fourier. His philosophy, had, however much in common with theirs. He believed that men are naturally good: evils are not inherent in the nature of things, but lie in the capitalistic system, which perverts the natural order. Haney, p. 429.

Owenite ideals but the Rochdale cooperatives were consumer not producer cooperatives and thus fell short of Owen's own vision of social redemption. Owen lived until the age of 87, a venerated but nevertheless disillusioned man[335].

Curious as well as significant is the fact that the British socialist movement, at its early stage, was greatly inspired by Owen - a wealthy manufacturer and a man regarded as an *utopian socialist*. Owen, not only inspired the socialist movement of his time, but also did what he could to improve the conditions of his mill-workers and he set an example to others of how to improve the working class' status at large[336]. His sensitive feeling was deeply affected by the inhuman and crude conditions of the industrial workers of the epoch and he made up his mind to dedicate his energy and money to the improvement of their lot. When he acquired his own cotton mills the working conditions of the textile factories greatly impressed him. He observed that a good number of the labourers were women and children - underfed, badly clothed and housed, and worked to the point of exhaustion. He could not tolerate this state of things any longer and, as a man of action, he immediately introduced radical improvements in the mills. He reduced working hours, raised wages, built model houses, initiated free education and placed all children under ten, whom he no longer employed, in the new schools. Children above that age were instructed during working hours. Moreover, in order to improve his workers' standard of living he set up a company store, which furnished better food and clothing at low prices. Fines for spoiled work were abolished, recreation was provided and insurance funds set up. Though the business did not seem to suffer from the resulting expenses, he had a hard time persuading his partners to consent to the expenditure involved. He even paid workers their full wages for four months during a depression period. The community of his workers was so clean, orderly, and pleasant that it attracted distinguished visitors from far and wide. Industry as a whole, however, failed to adopt his system.

Among the writings of Owen we note three important books; *A New View of Society; or Essays on the Formation of Character; Address to the Working Class; the Report to the Country of Lanark,* which were published in 1813, 1819 and 1821, respectively. In his most thoughtful

[335] Blaug, *Great Economists*, pp. 181-182.

[336] Owen's central idea was that *man is formed by the forces of his environment*, and this point of view caused him to stress educational reforms and the creation of circumstances favourable for bringing out the best in man. Spiegel, p. 440.

and comprehensive work, the *Report to the Country of Lanark*, Owen clearly stated his deep-seated conviction that a better environment could change human life and that this was confirmed by his own experience[337]. He also believed that it was futile to depend on paternalistic employers to bring about the desired change in conditions inasmuch as it was neither in their will nor in their power. This is because an increase in wages together with the addition of profit and other necessary costs made prices so high that wage earners could not buy what they had produced. Owen thus abandoned his activities of reformer to become an advocate of a system of communities[338] founded upon the openly socialist principles of united labour and expenditure, common property and equality of privilege, which would, in a short space of time, supersede the existing system of production and distribution. Owen made up his mind to try his scheme in his own establishment. As a first step toward the new systems, he decided to limit profit to five per cent. His partners rejected this action and as a result the firm was dissolved. He succeeded, however, in establishing a new firm with the participation of new partners, among whom was Jeremy Bentham.

The deep and worldwide depression, which marked the aftermath of the Napoleon, defeat in 1815 convinced Owen all the more to make a new start. Between 1824 and 1829 he attempted to translate his view of a co-operative society into reality by the establishment of a largely self-sufficient community of co-operative producers in Scotland and, later on, in the village of New Harmony in the State of Indians, U.S.A. Unfortunately, internal dissension wrecked the scheme and he returned to England. The failure of the schemes in Scotland and the United States of America not only caused the dissipation of a substantial part of his wealth but also convinced him that *the habit of the individual system were so powerful that* a communal effort for the *general good was* impracticable without previous moral training. Throughout his life he preached

[337] He believed that there were three barriers that were creating an obstacle in creating harmony among men and these he identified as private property, religion and the institution of marriage. In his ideal communal order, these barriers would be removed, and man's natural goodness could find free expression. Haney, p. 429.

[338] His theories of transforming society along cooperative lines were put into practice in such experimental communities as New Harmony, Indiana (1825), Orbiston near Glasgow (1826), Ralakine, Co. Cork (1831), and Queenswood, Hampshire (1839). See: Market House Books Dictionary of British History, 1987. Although these did not always succeed his ideas had important long-term effects on the development of the British socialist thought and on the practice of industrial relations. *The Oxford English Reference Dictionary,* 1996.

relentlessly that, unless a revolution was imparted to the moral character of men, no thorough economic change could be stable. His education programme envisaged education not as an attempt to put all men to a single pattern, but as an aim to impart to a community a common bend towards moral co-operation on the basis of which individual qualities might be fostered.
In 1832 Owen headed the *National Equitable Labour Exchange*,- the central market for the various co-operative groups formed by the trade unions, which had set up co-operative associations on his own model. In this central market anyone could deposit the products of his labour, receiving in exchange notes with a purchasing power equal to the number of hours spent on them. The notes could be used to purchase the deposited products. Thus there would be no difference in the total value between demand and supply. The attempt, however, failed because the commodities for sale did not attract enough buyers and, though no employer's profit was added to their price, they were not, apparently, regarded as embodying the full value of labour.

In spite of this particular failure and despite the fact that he met, for the most part, with unmitigated opposition, Owen, undeterred continued his preaching about the virtue of co-operatives, their creative influence on character of a better environment and the need for universal education. He helped to organise unions and was active in the rise of British trade unionism as an independent force. The great c*onsumers' co-operative movement*, which started in Rochdale, England, owes much to his inspiration, as does the British labour movement. He is also credited with being the first to use the word *socialism*. Though his writings were not intellectually profound, they exerted a tremendous influence on British socialism, probably more than did the writings of Karl Marx.

Other Socialist Thinkers

There were a number of social thinkers who were committed to the wellbeing of members of society, among others; space and time do not permit any exhaustive coverage. Also, it may be noted that there has been differences of approach. While some opted for a revolutionary radical change others were happy to see an evolutionary process to take place. In the following paragraphs, some of these social thinkers are reviewed.

Johann Karl Rodbertus (1805-1875) was a highly educated German scholar who aimed to bring about changes through evolutionary process. He maintained that there were two types of problems: distributive and recurring crises. The solution to the twin problems of distributive injustice and recurring crises was obviously the state of ownership of the property. The transformation of the ownership of the means of production was not to come in one stroke but rather through evolutionary stages. He believed that the eventual switch was inevitable. In this connection he identified three stages in history. In the first stage, human beings were themselves owned and their labour apportioned by their masters. In the second stage, there was private ownership of the means of production and other property. The third stage was the period when in which land and capital would be nationalised. Moreover, as society is organised on the principles of division of labour, for its health to be ensured, all three dimensions of the economy, production, exchange and distribution should be addressed[339].

Ferdinand Lassalle (1825-1864), is called the Louis Blanc of Germany, because of his advocacy for state-financed cooperatives. He believed that some action was needed to end the exploitation of labour by replacing competition and private ownership of means of production by something better. Moreover, since he believed that an individual could not control his own destiny, as he would be bound by external circumstances like crises, wars and overall social set-ups. Hence, the solution to the problem demanded a collective action in which the political power of the state would have the leading role.[340]

To this end, he entered the practical field by making the German workingmen's associations as his stepping-stone. He founded the General Association of German Workers, which later became the German Social Democratic Party. Furthermore, he advocated for the establishment of producers' cooperative associations supported by the state, but he opposed cooperative societies and credit unions!.

Mikhael Bakunin (1814-1876),a Russian refugee who lived in Switzerland and whose revolutionary spirit and activities influenced considerably the European social movement of the time derived his

[339] Bhatia, pp. 272-274.
[340] ibid., p. 275.

anarchic principle form Proudhon[341] and to these he added atheism. His methods, however, were quite different from those adopted by his mentor. Though his political ideas were always vague and changed rapidly, his instructions on organisation were precise and unchanging. Bakunin strove for the destruction of the state, which he regarded as an evil thing, and for the removal of the oppressors and their agents with the objective of establishing an anarchic order. He was a master conspirator and an advocate of terror and violence to destroy organised government[342]. It was these features rather than Proudhon's libertarianism that came to characterise anarchism in later years.

Bakunin was a powerful rival for Marx in the struggle for leadership of the First International (1864-78),[343] which indeed foundered as a result of this rift. They had irreconcilable views, and a conflict arose between them, which was subsequently fostered by a savage personal bitterness. Though Marx's objectives and methods were far superior to and much more consistent than those of Bakunin, the latter had, at one time, greater influence than the former on the socio-political movement of many countries. This is because anarchism, in the shape given to it by Bakunin, appealed especially to the backward and rural people in southern Europe [Spain and Italy] and to conspiratorial groups in czarist Russia,- regions that had been bypassed by the march of nineteenth century civilisation[344].

William Morris (1834-1896) was a British socialist who entertained humanistic outlook towards the working classes. In his writing he emphasised the necessity of introducing humanisation into industries. With this objective in mind, he extolled the virtue of handicraft both from the personal viewpoint of the craftsman and from the standpoint of honest and beautiful products. He condemned capitalism and industrialism and inspired by medieval models, preached for the realisation of human potential through craftsmanship[345].

[341] Spiegel, p. 451.
[342] ibid., p. 451.
[343] Marx was instrumental in founding the International Workingmen's Association [later known as the First International] in 1864, and guided it through six congresses in nine years. That organisation finally split in 1876 over the irreconcilable ideologies and personal antagonisms of Marx and Mikhail Bakunin, the Russian born anarchist. This also seems to indicate the beginning of the end of Marx's politically active days. Burtt, p. 140.
[344] ibid., p. 452.
[345] *The Oxford English Reference Dictionary,* Oxford University Press, 1996.

As a reflection of this view, the *British Guild Socialists* argued that industry caused human degradation since the industrial workers were condemned to routine, repetitive and monotonous processes, instead of being able to enjoy the creation of a finished product. The productive process, they maintained, should not set out the produce with an aim of serving the wants of the transient fancies of the consumers only, but should also render satisfaction to the producers themselves.

He was a leading figure in the *Arts and Crafts Movement,* and in 1861 he established Morris and Company, an association of craftsmen to produce handcrafted goods for the home. He is also noted for his poetry and many prose romances, especially *News from Nowhere,* written in 1891 portrays a socialist utopia[346].

Charles Kingsley 1819-1875 - In his book *Kingdom of Christ* [1838], Frederick Denison Maurice had argued that politics and religion were inseparable and that the Church should be involved in addressing social questions. Maurice's book rejected individualism, with its competition and selfishness, and suggested a socialist alternative to the economic principles of laissez faire. Later, Kingsley became a supporter of Chartism and when the British parliament rejected the Chartist Petition in 1848, he joined with F. D. Maurice and others to form the *Christian Socialist* movement. The Christian Socialists published two Journals: *Politics of the People* [1848-1849] and *The Christian Socialists* [1850-51], and Kingsley contributed several articles in them. The group also

[346] *The Oxford English Reference Dictionary*

produced a series of pamphlets under the title *Tracts of Christian Socialism.* [347]

[347] In 1850 Kingsley wrote a novel Alton Locke, which attempted to expose the social injustices suffered by the agricultural labourers and working in the clothing trade. This was followed by Hypatia (1853) based on real-life story of a philosophy teacher in 5th century Alexandria, who was murdered by a group of fanatical Christians because they disapproved of her political and religious ideas, and Two Years Ago (1863),.which discussed how poor sanitary conditions and public apathy cause an outbreak of cholera. In 1863 Kingsley published his most famous book, The Water Babies, which was initially written for his youngest son. It tells the story of a young chimney sweep, who runs away from his brutal employer. In his flight he falls into a river and is transformed into a water baby. Thereafter, in the river and the seas, he meets all sorts of creatures and learns a series of moral lessons.

XI. MARXIAN SOCIALISM

11.1 Introduction

It has been noted above that the socialist ideas began to germinate at the dawn of the seventeenth century. Traces of the first indications of revolutionary *socialism* go back to the period of the *reign of terror,* which accompanied the developments of the French Revolution, and, this vague plan took its concrete shape in the definite socialist programme of Babeuf and his fellow-conspirators, which, was aborted in 1796. Subsequently, other programmes, mostly utopian, were advanced, but all socialist thinking, movements and revolutionary agitations that dominated the nineteenth century attained their culmination in the more organised and systematised theories enunciated by Karl Marx and Friedrich Engels. Furthermore, the philosophy of Hegel, especially his dialectics, was to serve as a cornerstone for their analysis of history.

11.2 Georg W. F. Hegel (1770-1831)

The dominant figure in German philosophy during the nineteenth century was Georg Wilhelm Friedrich Hegel, whose ideas influenced not only Marx but also the German historicists. He was born in Stuttgart the son of revenue officer with the civil service. He was brought up in an atmosphere of protestant pietism and became thoroughly acquainted with Greek and Roman classics while studying at the Stuttgart gymnasium. In 1801 he went to the University of Jena where he studied, wrote and eventually became a lecturer.

While in Nuremberg he published the *Science of Logic (1812)*. In 1816 he accepted professorship in philosophy at the University of Heidelberg. The last full-length work published by Hegel was *The Philosophy of Right* (1821), although several of his lecture notes, supplemented by students' notes were published after his death.

Hegel's aim was to set forth a philosophical system so comprehensive that it would encompass the ideas of his predecessors and create conceptual framework in terms of which both the past and future could be

philosophically understood[348]. Such an aim would require nothing short of a full account of reality itself.

According to Hegel history holds the key to the science of society. History is not a sequence o accidental occurrences or a collection of disconnected stories; rather, it is an organic process guided by the human spirit. It is not smoothly continuous, but instead us the outcome of opposing forces[349]. Progress obtains, according to Hegel, when one force is confronted by its opposite. The logic that governs this developmental process is dialectic. In the struggle, both are annihilated and are transcended by a third force. This dialectical method involves the notion that movement, or process, or progress, is the result of the conflict of interests. *The thesis*, then, might be an idea or a historical movement. Such an idea or movement contains within itself incompleteness that gives rise to opposition, or *an antithesis*, a conflicting idea or movement. As a result of the conflict a third point of view arises, *a synthesis*, which overcomes the conflict by reconciling at a higher level the truth contained in both the thesis and antithesis. This synthesis becomes a new thesis that generates another antithesis giving rise to synthesis, and in such a fashion the process of intellectual or historical development is continually generated. This Hegelian dialectic was to be used by Marx in the analysis of history.

At the time of his death, Hegel was the most prominent philosopher in Germany. His views were taught, and his students were highly regarded. His followers soon divided into right-wing and left-wing Hegelians. Theologically and politically the right-wing Hegelians offered a conservative interpretation of his work. They emphasised the compatibility between Hegel's philosophy and Christianity. Politically,

[348] Ron Turner's Page at www.connect.net/ron/hegel.htm/ Hegel conceived the subject matter of philosophy to be reality as a whole. This reality or the total development process of everything that is, he referred to as the absolute or absolute spirit. According to Hegel the task of philosophy is to chart the development of absolute spirit. This involves making clear the internal rational structure of the absolute; demonstrating the manner in which the absolute manifests itself in nature and human history; and explicating the teleological nature of the absolute, that is, showing the end of purpose toward which the absolute is directed.
Concerning the rational structure of the absolute Hegel, following the ancient Greek philosopher Parmenides, argued that "what is rational is real and what is real is rational". This must be understood in terms of Hegel's further claim that the absolute must ultimately be regarded as pure thought, or spirit, or mind in the process of self-development.

[349] Ekelund and Hebert, p. 263.

they were orthodox. The left-wing Hegelians eventually moved to atheism position. In politics, many of them became revolutionaries. This historically important left-wing group included Ludwig Feuerbach[350], Bruno Bauer, Friedrich Engels, and Karl Marx. The latter two were particularly influenced by Hegel's idea that history moves dialectically, but they replaced Hegel's philosophical idealism with materialism.

11.3 Karl Heinrich Marx (1818-1883)[351]

Introduction

In the history of economic theory, Karl Marx holds a unique and paradoxical position[352]. He may be regarded, as the greatest prophet of modern socialism, as his writing are responsible for the powerful movement for the establishment of a new order, which the world is witnessing today. He was born in the Rhenish city of Trier to a successful Jewish lawyer of conservative views who converted to Christianity in 1824 *for social reasons*[353]. He studied law at the University of Bonn in 1835 and at the University of Berlin in 1836, changing his course of study that year to philosophy, under the influence of Ludwig Feuerbach, Bruno Bauer and the Young Hegelian[354] movement. Marx completed his doctorate in philosophy in 1841. With the accession of Friedrich Wilhelm IV in 1840, however, the Young Hegelians came under attack from government. The young Marx's articles soon wiped out the chances of an academic career and he turned to journalism instead. Between 1842 and 1843 he edited radical publications in the Rhineland, France and Belgium. He married his childhood sweetheart, Jenny von Westphalen, in 1843; but despite their exceedingly hard life after 1850, the marriage was

[350] Until 1839 Feuerbach's public persona was that of an innovative and independent-minded Hegelian. His Erlangen lectures, on logic and the history of philosophy were thoroughly Hegelian. But with the publication in 1839 of Towards a Critique of Hegel's Philosophy, he became a critic of Hegel, as well as interpreter. In the Biography by W.B.Chamberlain, Heaven wasn't his Destination: the philosophy of Ludwig Feuerbach (London, 1941). *The Oxford Companion to Philosophy*, Oxford University Press, 1995.

[351] This text is based on the Biography of Marx by Isaiah Berlin, *Karl Marx: His life and Environment,* 4th ed. (Oxford, 1978).

[352] Burtt, p. 137.

[353] Blaug, *Great Economists*, pp.154-157.

[354] …a *group of intellectuals who were turning the conservative philosophy of Hegel into a weapon of fierce social criticism*. ibid., p. 154.

a happy one. In 1844, while in Paris, Friedrich Engels[355] introduced him both to the working-class movement and to the study of political economy. It was while he was in Brussels that Marx formulated the programme of historical materialism, first expounded in the unpublished manuscript *The German Ideology.*

Marx returned from Belgium to Paris in 1848 after the revolution, and then went back to Rhineland where he worked as a publicist on behalf of the insurrection there. In the same year, Marx and Engels played a key role in founding the Communist League [which lasted until 1850]; and the famous *Communist Manifesto* was first published in 1848 as part of their activity in the league. During the same year he was expelled from Prussia territories for treason, and after a brief stay in Paris he took up residence in London.

Throughout the 1850s and 1860s, when not confined to bed by illness, Marx regularly spent ten hours of every day in the library of the British Museum studying and writing. His first scientific work on political economy, *Contributions to the Critique of Political Economy*, was published in 1859. The preface of this work contains a succinct statement of the materialist conception of history, usually regarded as a definitive formulation of that doctrine. This was only a prelude to Marx's definitive theory of *capitalism*. Volume of capital was published in 1876, but two more volumes were left uncompleted at this death. Engels edited and published them in 1884 and 1893, respectively.

The Marxian Premises

The three principal Marxian premises are class struggle, surplus value, and revolutionary cycle.

Class Struggle - Pre-Marxian economists and historians were aware of the concept of class struggle, and the first who wrote about the existence of two separated classes in a modern society was Sismondi. He had maintained that the class of a few rich and that of a majority of people living in utter property: the capitalists and the workers who were in constant conflict because their interests were opposed. The phrase *class struggle* was first used by August in Thierry (1795-1856), the historian of the Bourgeois revolution in France, and who is regarded as *the father of*

[355] Engels was a fellow member of the Young Hegelians and a former fellow student at Berlin, with whom he began a lifetime of collaboration.

the class struggle in the French historical writing. However, Marxism's fundamental proposition holds that the great character of the various processes of life is fundamentally determined by the mode of production in material life. This is known as the *economic or materialistic interpretation of history*. From this stems Marx's assumption that the entire history of society is merely a record of class struggles. *Who holds economic power,* Marx argued, *holds the political power or the state* and this is the central fact in all history.

Surplus Value - The existence of surplus value, Marx believed, was responsible for the origin and fostering of the class struggle. He also maintained that labour alone produced all wealth and ought to be entitled to the full value of its creation. He reduced all labour to *simple average labour*, regarded land as merely a passive agent, and capital as the product of past labour. Furthermore, he held that the exchange-value of everything is determined by the labour-time socially necessary to produce these products. But, he pointed out that the workers are paid no more than enough for meagre subsistence and the propagation of their race. Employers, on the other hand, pocket as profit the difference between what they pay their workers and what the latter produce. Hence, capitalist society is characterised by the exploitation of the working masses - a robbery, which takes place in the form of profit or surplus value.

Revolutionary Cycle - It has been noted above that because of surplus value, which is pocketed by capitalists in the name of profit, the capitalists become richer and richer while the workers remain poor. Industry, on the other hand, becomes concentrated in larger and larger business units, as wealth and income come increasingly into the hands of an ever-diminishing number of people. Production increases, but the consuming power of the labour force relatively decreases. The result would be a period of depression. Though, however, periodic depressions are for a time offset by various expansionist stages of capitalism, economic crises become more acute with the drying up of both foreign and domestic markets. Society becomes increasingly rent by devastating crises and enters upon a period of industrial decline leading inexorably to the collapse of the capitalist order. As class struggle is intensified, the rich grow fewer and richer, the poor more numerous and poorer. As a result, class consciousness will be intensified to an extent that the working population, aware of their power and the precarious conditions in which they live, will revolt and capture political power to establish their dictatorship, the *proletariat dictatorship,* which will, subsequently be followed by the emergence of the *class-less* society.

The Economics of Karl Marx

Marx's approach to the study of the economy is unconventional. Orthodox economic theory, particularly microeconomic theory, attempts to understand the whole of the economy through the examination of its parts. Marx on the other hand, started at the level of the total society and economy and analysed them by examining their influence on their component parts. Thus in orthodox methodology the major causation runs from the parts to the whole, whereas in the Marxian scheme the whole determines the parts[356]

The economic theories advanced by Marx are almost wholly classical; his method of reasoning, like theirs, was deduction from a few relatively simple postulates. Whatever the merit of his economics and any criticism of his views will be equally shared by the classical economists. The only difference between the classical economists and Marx is that while the former propounded their theories in defence of *capitalism,* the latter used it as weapon to attack and undermine the *capitalist system.*

The Labour Theory of Value – In his *Contributions to the Critique of Political Economy,* Marx described the determination of value by labour time to the labour expended on them. Marx essentially used Ricardo's theory of value[357]. However, he maintained that, in order to produce value, the labour must be *socially necessary*, i.e., its product must be of value to somebody. As markets develop, value in exchange may be measured in terms of money. Money paid by the consumer for any article, therefore, is the payment for the socially necessary labour that went into that article. Money is the intermediary. Marx distinguishes two processes in the circulation of commodities. The first, in its simplest form, can be illustrated by this formula **C - M- C,** where, **C** stands for commodity and **M** stands for money. According to this formula, a commodity is sold for money and with this another commodity is purchased. In this case *use-value* is the aim. The second form of circulation is explained by, **M- C-M'**. Money is employed with the purpose of purchasing commodity with the aim of selling it for money. In this form, money acquire the character

[356] Landreth and Colander, pp. 183-184.
[357] ibid., p. 185.

of capital and **M'** is greater than **M.** The aim of the second circulation is *exchange-value*, and it is on this circulation that surplus value arises[358].

The Labour Theory of Surplus Value - As the formula **M-C-M'** attempts to show, the capitalist does not purchase articles for use, but for resale, i.e., he is interested in the exchange-value of the commodities. Since the resale price is greater than that of the purchases, M' is, as it were, greater than **M** in the above formula. It is on this circulation that surplus value arise and its extent depends on the greatness of **M'** in relation to **M**.

To grasp Marx's concept of surplus value we must first understand how the exchange- value of labour power is determined. Like that of every other commodity, it is formed and measured by the amount of socially necessary labour time, which is required for its production. It is determined by the amount of socially necessary labour-time that is embodied in the labour's means of subsistence, i.e. in their exchange-value. These means of subsistence are traditionally determined but must also be large enough to ensure the perpetuation of the labouring class, by permitting the labourers to procreate themselves.

The capitalist buys labour power and sets it to work. He makes labourers embody their labour is commodities, i.e., in materials and means of production. The exchange-value of these materials constitutes part of the exchange-value of the finished products. To this must be added the labour-time spent on its production measured as the necessary social average. Thus the capitalist has paid for its exchange-value, determined by the socially necessary labour-time embodied in the labourer's means of subsistence. Human labour power can be expended in a longer time than that which is required to produce it, and it is on this ability that surplus value depends.
Let us assume, for example, that it would take only four hours of labour to produce the worker's means of subsistence for a whole day. As the employer needs to offer no more than is required to maintain the supply of labour, he will pay a wage equivalent to the minimum of subsistence, or for four hours of work. But he will require his employee to work more, say, for eight hours. Let us also suppose that if improved efficiency of the worker (a higher productivity) can be attained by the introduction of new

[358] On the highest level of abstraction Marx disregarded the differing skills of labour and conceived of the total labour available to society for commodity production as a homogeneous quantity, which he called abstract labour. ibid., p. 185.

machinery or training, and this enables the worker to double the output, would the employer double the wage of the labourer? Not at all; the employer will retain the surplus value for himself. This gives an explanation of the way in which privately owned capital is accumulated, since, if the capitalist were to pay out for labour all the money he received, he could accumulate nothing. In this theory, Marx does not imply that the productive system needs no capital in the sense of *capital goods,* such as machinery or buildings. On the contrary, Marx admits that the purchase or possession of such goods for the purpose of production is a necessary part of any social system. When he implies is that private employer has no right to claim such goods as his own but that they should be, in essence, the payment for the labour that produced them. If the workers should come to possess the instruments of production, they would presumably set aside a portion of their earnings to pay for new machinery and buildings.

It is, therefore, evident that according to Marx, the employer, by paying the worker only enough to keep him and his family alive, instead of paying him what he collects from the customer (which is the true value of the labour embodied by the sold article), decidedly accumulates wealth for himself. In doing so, the capitalist is *robbing and exploiting* the worker.

Though Marx, in thus putting together the classical theory of value and the classical theory of wages to demonstrate the injustice of capitalism, was preceded by a German economist, Johann Karl Robertus, still Marx deserves high praise for presenting it in a more organised and systematised way.

The Theory of Accumulation – The accumulation of capital was the overriding objective of capitalist society. Marx's analysis of the accumulating economy sought to explain the historical development of capitalism, especially the British system, and to demonstrate its effects on both the capitalists and the workers. For analytical purposes, he distinguished between simple reproduction and accumulation. In the first case, the capitalist consumes all the surplus value he receives; new savings and investment are zero. In the second case, the capitalist constantly exceeds his capital[359].

[359] Burtt, p. 152.

Marx also distinguished between primitive and capitalist accumulation. Primitive accumulation precedes the development of the capitalist mode of production and is therefore its starting point. In European and British history especially, the period of primitive accumulation included both the agrarian revolution and the commercial revolution. It was characterised by a build-up of private wealth in the hands of merchants and master manufacturers on the one hand and the expropriation of labourers from the land on the other. The historical process said Marx, was one in which force was *midwife* for the new society of capitalism that wrenched peasants and yeomen from the soil, turning them into a property-less class dependent on the free market. The discovery of gold the use of slavery, the colonial system, and even the growth of the public debt all contributed to the initial accumulation of investment capital[360].

In capitalist society, accumulation proceeds by investment of the surplus value that arises from employment of free labour. As Marx observed the process in Great Britain, he drew several conclusions. Extending Adam Smith's analysis of the division of labour, he argued that as technology improves investments are made in machines and factories, in fixed capital, and in the larger establishments that are needed to take advantage of the lower costs of a greater division of labour. The development of capitalism meant a tendency toward the concentration of capital in particular firms and, at first, toward greater competition among more capitalists. From this competition emerged the stronger capitalists who were able to gain the upper hand over their competitors and centralise the ownership of capital. To the degree that such men are successful, the centralisation of capital further accelerates the process of accumulation. The larger firms, headed by the successful capitalists, increase their exploitation of new inventions and discoveries and gain competitive advantages that lead to the expropriation of smaller firms[361]. These tendencies, which Marx believed were basic features of capitalistic development, tended in turn to cause the rate of profit to decline.

Thus, the Marxian laws of capitalism include a reserve army of the unemployed; a falling rate of profit; business crises; increasing concentration of industry into fewer firms, and increasing misery within the proletariat[362]. Hence, Marx deserves, credit for being one of the first economic theorists to emphasise an obviously critical defect of the

[360] ibid.,pp. 152-153.
[361] ibid., p. 153.
[362] Landreth and Colander, pp.192-193.

capitalist system. Furthermore, Marx's legacy is that he has had a profound influence on the twentieth century, and it is a testimonial to his far-ranging intellect that this influences has surpassed the boundaries of economics alone.

11.4 Friedrich Engels (1820-1895)

Friedrich Engels was born into a wealthy Prussian family in Bremen, Prussia. At the age of seventeen he joined his father's business office and was afterwards he was sent to look after the family's interest in the textile mill located near Manchester. His inclination towards scholarship made him read so many books that he became, while still young, a scholar of high calibre.

On the other hand, the sight of the working conditions of the industrial workers of his time impressed him so deeply that he not only joined the workmen's agitation of his days but also dedicated much of his time and energy to finding out a scholarly solution to the problem of the working class. His work is closely linked with that of Karl Marx whom he met for a second time in 1844 in Paris and became his life-long friend and collaborator. However, although he was dwarfed by the fame of Marx, it is clear that he was a scholar on his own right[363]. Amongst some of his work are: *The Condition of the Working Classes in England* (1845)*; The Origin of the Family, Private Property, and the State* (1884), *and Socialism, Utopian and Scientific* (1891). After the death of Karl Marx, he edited and published Volume two and three of *Das Kapital* out of the voluminous manuscripts left by Marx himself.

[363] The Communist Manifesto, which was published in 1848, was the result of collaboration between Marx and his remarkable companion, compatriot, supporter, and colleague, Friedrich Engels. Heilbroner, p. 139.

XII. THE GERMAN HISTORICAL SCHOOL

12.1 Introduction

During the middle years of the nineteenth century there arose in Germany an almost violent reaction against the dominant economics of Adam Smith and David Ricardo. This reaction found its expression in criticism of the philosophy and the methods of the earlier economists. We have noted earlier that Hegelianism as a social theory regards the course of culture as an unfolding of the human spirit. There were developments in jurisprudence, philology, and law, which expressed nationalistic ideas. In addition, the economist and political scientist Lorenz von Stein (1815-1890), aware of the French Socialism and a realisation of the interrelationship of philosophy, economics and law, with a considerable touch of the historical idea, was influential in applying Hegelian ideas to economics. Thus, what members of the Historical School did was take all these tendencies and acting under stimuli just mentioned to formulate them in broad, scientific way, while concentrating attention upon the problem of method[364]. There were two phases in the development of the historical school: the older and less extreme group and younger historical school, whose views on method were more extreme and uncompromising.

12.2 Wilhelm Roscher (1817-1896)

The emergence of the German Historical School thus arose as their reaction against the classical school of economics and its method of analysis. First among the older German historical economists was Wilhelm Roscher, who thoroughly understood the Classical School, and in his positive theoretical writing was at one with it. In his famous *Outline of Lectures on Political Economy,* published in 1843, however, he laid down the following program[365]:

-Political economy is a science, which can be explained only in the closest relation to other social sciences, especially the history of jurisprudence, politics and civilisation;

[364] Haney, pp. 537-539.
[365] ibid., 540.

-A people is more than the mass of existing individuals, and an investigation of its economy cannot, therefore, be based upon a mere observation of present-day economic relations;
-In order to derive laws from the mass of phenomena as many peoples as possible should be compared. Ancient peoples, having run their full course, are particularly instructive; and similarities between the old and new are especially fruitful;
-The historical method will be slow to praise or blame economic institutions, for there have been few that have been entirely good or entirely bad for all peoples.

Accordingly, Roscher denied absolute truth as to the general economic laws.

12.3 Bruno Hildebrand (1812-1872)

Hildebrand's book *The National Economy of the Present and Future*, was published in 1848, writes brilliantly and clearly[366] contended that classical economic theory did not apply to all times and places. He stated that the Classicists forget that man, as a social being, is always a child of civilisation and a product of history, his wants, his character, his relations to goods and men being ever changing. Moreover, they are atomistic, making the individual the end of society, and holding that society itself is based upon an exchange contract private advantage being regarded as the source and bond of the community. Hildebrand believed that the present money economy is only transitional to a more complete stage of development, which he called credit economy[367]

12.4 Karl Knies (1821-1898)

He was the most thorough and logical expositor of the historical method. His work, *Political Economy from the standpoint of the Historical Method* appeared in 1853. Like his fellows he attacked absolutism in theory. No economic law can be declared absolutely final, for they concern points in a *constantly unfolding evolution*, and can do no more than reflect a progressive manifestation of the truth. *The truth of all theories, which have their foundation in empirical life, rests upon concrete hypothesis. Relativity*

[366] ibid., pp. 541-542.
[367] ibid., p. 542.

in the validity of their conclusions or judgements is a necessary result of the circumstance that those hypotheses do not remain identical nor occur constantly in all times, places and circumstances[368].

Knies dwells upon the fact that the concept of private property has been a changing one and that self-interest often conflicts with the social welfare. And he calls attention to the fact that various ideas as to what kinds of labour are productive have prevailed.

12.5 Gustav Von Schmoller (1838-1917)

He represented the Younger Historical School or the more positive of thinkers. They were determined to apply historical method, as they conceived it, in a thoroughgoing way to concrete ideas. They even refused to recognise a difference between the purposes and methods of economic theory and economic history[369]. Chief of these was Schmoller who at the end of the nineteenth century was one of Germany's leading economists.

In 1895 Schmoller by way of explaining the differences between the older and younger generation of members of the German Historical School wrote: *The older historical political economy has repeatedly desired to turn too quickly to account the lessons of universal history; we are now aware that laborious inquiries into details of economic history can alone supply the right basis for the study of history in its economic and socio-political aspect, and for the satisfactory empirical establishment of national economic theory*[370]. Schmoller, pushing Roscher's historicism to extremes, argued that all received economic analysis, mainly Ricardian, was not only useless but also pernicious. He drew up sharp lines of demarcation in the debate over method: he contrasted the method of the classical economists and the neoclassical Austrians, especially Menger, who were defending and employing what he regarded as abstract deductive argument, with the historico-inductive method of the German school[371].

Schmoller seriously proposed that received theory be completely discarded, owing to the unrealism assumptions, to the degree of theoretical abstraction, and to the neglect of interrelated and relevant facts. The resultant gap would

[368] Quoted in Haney, pp. 542-543.
[369] ibid., p.545.
[370] ibid., pp. 545-546.
[371] Ekelund and Hebert, pp. 220-221.

ultimately be filled by historical laws of development, laws that Schmoller attempted to discuss in numerous publications including in *Outline of General Economic Theory,* the most massive attempt in the literature to capture historical laws in a systematic treatise.

Like the members of the older historical school, these writers attacked the classical economics theory, particularly the view that it was applicable to all times and places. Generally much less ambitious than the older school in their application of the historical method, they were content to write monographs on various aspects of the economy and society rather than to formulate grand theories of the stages of economic development. In this endeavour they preferred to use inductive methods and seemed to think that after enough empirical evidence had been gathered, theories might emerge. They also were very interested in social reform through state action. Because of this they were called *socialists of the chair* an epithet they happily accepted, contending that their critics who would not accept proposals such as income taxation were reactionaries[372].

Though Schmoller, in his earlier writings, did not recommend the construction of abstract models, he was willing to admit that both methodologies had a place in economic investigation. Thus, while the older Historical School stressed a shift from deductive logic of the classicists and insisted that the study of economics should turn to history to discover the realities of economic life [inductive analysis] and emphasised the evolutionary aspects of economic laws, it was handicapped by the lack of statistical data and it goes to the credit to the younger school that its members could provide as much of insight into historical facts as they did. The younger school was less handicapped that way. While the older school was, more or less, content to supplement the classical theories, the younger school wanted to have nothing with deduction. They proposed to reconstruct the entire science of political economy by the historical method alone. This group is characterised to undertake upon itself the task of collecting the necessary vast bulk of systematised data, through an endless stream of monographs.

In general, the historical school questioned the validity of the abstract method of analysis adopted by the classical school. It refused to follow an approach wherein the conclusions are drawn *a priori* grounds on a deductive basis and then historical facts are appended to (if at all) to

[372] Spiegel, p. 426.

substantiate the conclusions. Instead it chooses to follow the inductive method of analysis, in which generalisations follow the historical facts.

12.6 Evaluation

It has been noted that the historical school was basically a German, reaction to the classical school. During the last quarter of the nineteenth century, a number of English writers criticised orthodox classical theory and advocated the historical approach to the study of economics. These writers did not form a cohesive group as in Germany, nor were they influenced directly by German writers. The English tradition in economic thought was no stranger to the historical inductive approach. Adam Smith's *Wealth of nations* was a blend of historical and descriptive material tied together with a loose theoretical structure. Ricardo represented a major shift in the methodology of economics toward the building of abstract deductive models almost completely devoid of historical or institutional content. Senior supported the view and extended Ricardo's use of deductive reasoning. J.S.Mill and Alfred Marshall, however, moved back in the direction of Smith's methodology using his great scholarship and knowledge of historical and institutional material to give substance to his theoretical structure. Leslie maintained that Smith's economic theory was not applicable to the contemporary English situation but that on balance Smith's methodology was reasonably sound, because Smith made extensive us of historical material at arriving at his conclusions.

One thing is however clear, that the critical and searching attitude of the historical economics was instrumental in bringing the deductive and historical concepts together, whereby the much needed enrichment of the science of economics was achieved. A widening interest in several branches of economics could feed itself upon the richness and support mutual feedback between theory and evidence. This development aroused interest and led to the collection and dissemination of all kinds of statistical information and in turn led upon increasingly available mass of information.

Although the historical school has not had a major impact on recent developments in theory, its lessons remain valid and have influenced many of the critics of economic theory. On the one hand, the classical school had abstracted from a number of forces and concentrated upon selected forces to analyse the economic principles. The historical school on the other hand,

tried to bring in all the determining principles. A section of them even went to the extent of maintaining that the very existence of economic generalisations can be ascertained only when enough historical materials have been collected and studied.

Basically the historical school opposed to the abstract and deductive approach of the classical school and tended to preach the opposite wherein abstraction gets totally replaced by historical studies. These two opposite tendencies eventually fused into each other and enriched economic science in more than one way. As a result, now the importance and rationale of both methods are recognised and the other supplements one.

XIII. THE AUSTRIAN SCHOOL

13.1 Introduction

The Austrians were instrumental in the tool of the margin and in popularising its use[373]. In fact, it may be said that Carl Menger put the cornerstone for the school with his publication of [*Grundsatze der Volkswirtschaftslehre*] *Principles of Economics* in 1871. Menger felt that economic theory had fallen into disrepute with many scholars, and he sought to restore it to its place of honour by freeing it of inconsistency and basing it upon more fundamental laws of causation[374].

13.2 Carl Menger (1840-1921)

Carl Menger, although one of the trio credited with the marginal revolution of the 1870s, differed in many significant ways from both Jevons and Walras. The content of his theory, the way it was formulated, his attitude towards mathematics, and his subsequent influence are among these differences[375].

Menger's father was a lawyer and young Carl studied law at the universities of Vienna, Prague and Cracow, and then entered the field of journalism, where for the first time he became interested in economics. He later worked for the Austrian civil service, during which time he completed his first book *Principles of Economics (Grudsatze der Volkswirtschaftslehre).* Published in 1871. It contributed to the beginning of the marginal revolution in economics and laid the basis for the subjective economics of the Austrian school. Two years later, Menger obtained appointment as professor extraordinary at the University of Vienna, but soon left to become a private tutor to the young Crown Prince Rudolph. For two years, he travelled with the prince throughout Europe; he the returned to the university, his time as an ordinary professor of political economy. His second major work, *Problems of Economics and Sociology,* which appeared in 1883, brought his theories to a wider audience. In this work, he attacked the historical approach to economics then characteristic of the leading economists in Germany and gave an

[373] Bhatia, p. 311.
[374] Haney, p. 608.
[375] Staley, p. 146.

ardent defence of his own theoretical method. Gustav Schmoller, the current leader of the German school reacted swiftly in defence of his position; and the argument over method [known as *Methodenstreit*] suddenly gained international attention. As followers of each economist also sprang into the dispute, the cleavage between the two points of view was deepened by the fact that both Menger and Schmoller held such commanding positions in the educational establishments of their respective countries and that could virtually close teaching opportunities those who professed allegiance to the other side. Although *Methodenstreit* gradually died out, the issues raised were far from resolved. Schmoller eventually admitted the importance of theory; using both deduction and induction, he said, was as necessary as using the right and left foot in walking. But there was no agreement on the either the nature of theory or the purposes of historical research. Only gradually was it recognised that Menger's attack on the German historical school had included a vigorous criticism if British classical economics[376].

Menger devoted most of his career to teaching of economics to students of law. Apart from his teaching Menger found time to write many articles and memoranda, as well as testimony on Austrian currency reform in the 1890s, and he also collected an imposing library of some 25,000 volumes[377]. Retiring early in 1903, he turned to the task of enlarging his *Principles of Economics*, which was not published in his lifetime.

On the level of technique, he objected to the use of mathematics, which could not help discover the *essence* of economic transactions. As for the aims of his book, *The Principles of Economics,* he said he wished to establish whether and under what conditions the following held: if it is a good; if it is an economic good; if it has value and what the measure of value is; if an economic exchange will take place; and finally the limits which a price can established. However, with the benefit of hindsight, it can be seen that what Menger emphasised compared to his colleagues from England and Lausanne are considerations dealing with economic progress, with changes in the range and quality of goods because of changes in information standing out as a major part of his exposition[378].

Merger said that all things are subject to the law of cause and effect. In economics the human want is the fundamental thing. Things, which have

[376] Burtt, p. 175.
[377] Staley, p. 146.
[378] ibid., p. 147.

the capacity of being placed in causal connection with the satisfaction of human wants, are utilities. To bring an object into the sphere of economic causation four conditions are necessary: a human want; such properties of the thing as make it capable of being placed in causal connection with the satisfaction of this want; the recognition of this causal relationship by man; and the power to dispose of the thing so that it can actually be applied to the satisfaction of the want[379]. With such an analysis Merger sought to arrive at ultimate causes, and to draw an explanation of value from the economic activity of the individual. Merger considers value as an individual objective and he defined it as *the significance which concrete goods or groups of goods gain for us through the fact that in the satisfaction of our wants we are conscious of a dependence upon the disposal of them*[380].

Menger put his value theory in the centre of a pattern of economic development from primitive life to modern capitalism. Modern [i.e.,1870] man must plan and control production, which is based on scientific knowledge and on the use of capital. Capital is viewed as a collection of goods at various stages or distances from final consumer[381]; and the goods are divided into different classes, or orders, according to their nearness to the consumer[382]. Differences in value are due to the different estimations, which men put upon the satisfaction of various wants. The value of a concrete good, or of a certain aggregate, at the disposal of an economic man is equal to the significance of the least important want satisfactions yielded. Thus, over and over again, Menger repeats the statement that value and the measure of value are subjective and dependent on wants[383].
In the market economy, trade enables one to give up something on which he places a low value in return for something, which has, for him, a higher value. Menger explained that goods are valued differently both because they satisfy different needs, and because increasing the supply of the same good fills less pressing requirements for the same need. In his now famous table shown below, needs are labelled I, II, III, etc., with the most significant having lower numbers (food is I). The columns under

[379] Haney, p. 608.
[380] ibid., p. 608.
[381] Staley, p. 147.
[382] Bread is in the first order; flour in the second; wheat in the third, etc. Goods of the last description are of 'higher order' and their value is reflected back from those of the 'lower order'; wheat has value because and in so far as men want bread to maintain life and well-being. Hanley, p. 609.
[383] Haney, p. 609.

each need show the additions to total satisfaction of additional units of the good meeting that need[384]. Technically, the graph is known as a lexicography and it appears that Menger had in mind that numbers in the ordering represented an ordinal than a cardinal scale of marginal utility. He discussed at length how to allocate a good that meets several needs; for example, if good *x* could be used for the needs met by goods I and II, and if a consumer has five units of *x*, he should use 3 units for the first need and 2 for the second, as this equates the marginal utilities at 8. Using 4 units of the first need and 1 for the second is wrong, as the next unit in need II would give a satisfaction of 8 rather than 7 yielded in need I. Although he claimed that this sort of valuation was related to price, he did not consider the opposite problem, of several goods meeting the same need. Indeed, Menger made no attempt to derive demand curves from the underlying utility functions, he stated that *the value of a particular good or of a given portion of the whole quantity of a good at the disposal of an economising individual is thus for him equal to the importance of the least important of the satisfactions assured by the whole available quantity and achieved with any equal portion,* and that *the prices of actual labour services are governed, like the prices of all goods, by their values*[385].

Menger's Partial Table of Diminishing satisfaction

	Goods				
	I	II	III	IV	V
	10	9	8	7	6
Marginal	9	8	7	6	5
Utilities	8	7	6	5	4
	7	6	5	4	3
	6	5	4	3	2
	5	4	3	2	1

If his theory of demand was weak, his theory of supply was non-existent. This was because he believed that value depends on the utility of the last unit: *whether a diamond was found accidentally or was obtained from a diamond pit with the employment of a thousand days of labour is completely irrelevant for its value*[386].

[384] Staley, pp. 147-148.
[385] ibid., p. 148.
[386] ibid., p. 148.

Thus, although Menger did not utilise costs in the determination of value, he did make important contributions to the theory of production and to the determination of the values of the factors of production. One of these was that the proportions in which inputs are combined are not fixed but variable. Another was that in capitalism there is a hierarchy of production, in which the consumer goods [called goods of the first order] are produced by other, higher-order goods as well as by labour and land. The higher goods' value is derived from the value of the consumer goods they produce; this is called the theory of imputation[387].

While Menger did not emphasise the market price as being centre of economic science warning that it is only an *incidental manifestation that* it was simply the *symptom of an equilibration between the economics of individuals.* He discussed the formation of this market price between two individuals, what is now known as bilateral monopoly, showing how the final terms of trade depend on bargaining strength. Then he discussed the effect of more traders entering the market and how the limits of bargaining are lessened, because the final terms of trade must lie between the amount offered by the individual who offers the least and still participates in trading and the amount that would be offered by the individual who offers the most of those excluded from the trade. The more people in the market, the closer are the offering of these two people. When the markets become large in developed economies speculators and middlemen keep the market price close to a genuine competitive equilibrium[388]

In his analysis of money, included in his *Principles of Economics*, he applied subjective theory of value. The origin of money, he held, is not to be sought in an explicit convention or in the action of public authorities. Instead, it was the interest of economising individuals, which led them exchange their goods for other, more saleable, goods. Money is the most marketable good and its value is determined in the same manner as that of other goods that are objects of exchange transactions. In this interpretation, money was introduced by design and in consequence of a plan but as an unintended result of the unconcerted actions of a multitude of individuals pursuing their own interests[389].

[387] ibid., pp. 148-149; Spiegel, pp. 534-535.
[388] Staley, p. 149.
[389] Spiegel, pp. 536-537.

Among the young Austrians who continued to support Menger's original theories relatively unchanged were Ludwig con Mises (1881-1973) and Friedrich von Hayek[390] (1889-1992). Mises criticised pricing under socialism, believing that rational economic behaviour was impossible under non-individualistic conditions. Hayek's principal contributions were in the field of business cycles. In general, he defended and extended Bohm-Bawerk's theory of capital. Other prominent economists for their contributions to economic analysis but significantly influenced by the Austrian theory were the English Phillip H. Wicksteed (1844-1927), the Swede, Knut Wicksell (1851-1926) and the German Joseph A. Schumpeter (1883-1950)[391].

On the other hand, Menger's important followers were Friedrch von Wieser and Eugen von Bohm-Bawerk (1851-1914). Classmates and friends, and eventually brothers-in-law, the two were not, strictly speaking, students of Menger's but came under his intellectual influence when in their early twenties read Menger's *Principles of Economics*. Because of Menger's early retirement Austrians who became prominent, including Hayek, Mises and Schumpeter, were not students of Menger but rather of Wieser and Bohm-Bawerk, who held a variety of teaching posts in the far-flung Hapsburg empire of the time[392].

13.3 Wieser and Bohm-Bawerk

The two junior members of the original Austrian school had quite different personalities. Bohm-Bawerk was indefatigable controversialist and close student of economic literature Wieser was noted for Olympic detachment from controversies of his time and restricted to reading to regimen of intellectual hygiene. Nevertheless, Wieser's intellectual interests were broader than Bohm-Bawerk's or even Menger's and included work in sociology. On the other hand, distinguished as their accomplishments were, neither had a mind equipped with the creative originality of Menger[393].

Although both tried to highlight the work of Menger in the writings of Wieser and Bohm-Bawerk there emerged what from then on was to become characteristic of the Austrian tradition in economics – a critical reaction to

[390] He won the Nobel Prize in Economics in 1974
[391] Brutt, p. 177.
[392] Spiegel, p. 537.
[393] Spiegel, pp. 537-538.

the work of Karl Marx. This reaction, which was mild in the case of Weiser, became stronger under Bohm-Bawerk and the young Austrians, who expanded their attack to include not only Marxian socialism but also reform socialism and economic intervention in general. In a world that had abandoned laissez faire, the Austrian s became its last defenders[394].

Friedrich von Wieser (1851-1926) **-** The next important step in the development of the Austrian theory comes with the publication in 1884 of the *Source and Principal Laws of Economic Value* by Friedrich von Wieser. He built upon Menger applying his theory to the phenomena of costs and distribution, and deepening the psychological analysis. In his later thought, he worked out a theory of objective value, though not independently. His statements of what gives economic value are complicated but they read as follows. If the things are capable of producing useful effects; if their supply does not equal the employment for them; if they allow encroachments by men which, when economic increase their usefulness, and, when uneconomic, decrease it; if all subjective suppositions which complete these objectives one agrees; and if, then, the existence of the good, its utility, and other external circumstances are perceived; if the need for it is not only distinct, but also its satisfaction is desired; and if the purpose is formed to do the economic acts which show themselves practicable while shunning the temptation to uneconomic action, - then will the interest be transferred from the expected economic use to the goods, and become associated with them, i.e., then the goods receive economic value[395].

In his *Natural value*, published in 1889, he expresses himself more boldly; saying,… *In a word, the value of a supply of similar goods is equal to the sum of the items multiplied by their marginal utility.* This of course implies a divisible good with more than one unit of supply; and Weiser states that the law rests upon the existence of scales of want and the *fact that goods come forward in stocks or supplies consisting of similar items*[396]

Moreover, in the same book, Wieser attempted to demonstrate that economic value is a *natural* category in the sense that any rationally ordered society, regardless of its institutions, would have to make valuation. He drew the important conclusion, which set a precedent for the later study

[394] ibid., p. 538.
[395] Haney, p. 610.
[396] ibid., pp. 610-611.

of the economics of socialism, that a socialist economy could not dispense with valuations. Although he stressed the relevance of the subjective theory of value for a socialist state, he, as well as Bohm-Bawerk, rejected the labour theory of value and subjected it to searching criticism, the latter in a volume entitled *Karl Marx and the Close of His System* (published in 1896) which for a generation was the leading criticism of the work of Karl Marx[397].

Eugen von Bohm-Bawerk (1851-1914) - This Austrian economist was one of the immediate disciples of Menger. He opened his important contributions in 1884 with his well known *Capital and Interest,* a critical history of economic theory; following with a monograph, *Outlines of the Theory of Commodity* Value (1886) and his master piece, the *Positive Theory of capital* (1888).

Bohm-Bawerk is notable not only for independent thought, but also for clear exposition and illustration, and a *careful and fruitful revision of many matters of detail* he elaborated the division of labour into subjective and objective – with which he would replace the old division into use-value and exchange value, - and one of his distinct merits lies in his treatment of objective value or purchasing power. He was the first amongst the Austrians that gave a well-rounded attempt to bridge the gap between the subjective and objective, and to develop a complete theory of objective exchange value and price[398].
Subjective value is defined as the significance, which a good acquires as the recognised condition of a use for well-being that would have to be forgone without the good. The amount of value depends upon the amount of gain in well-being which the good brings, or what want would remain unsatisfied without it. *The value of a good is determined according to the importance of the concrete want or increment of want, which is the least important of those met by the supply of such goods at disposal,* that is, by its marginal utility[399].

Bohm-Bawerk distinguishes between two sorts of value: subjective use-value defined as above, and subjective exchange value. The latter is *the importance, which a good obtains for the welfare of a person through its capacity to procure other goods,* and its amount coincides with the use-

[397]Spiegel, pp. 538-539.
[398] Haney, p. 615.
[399] ibid., pp. 615-616.

value of the goods received in exchange. Commonly, use and exchange subjective values differ from one another, in which case the higher of the two sets the value. However, the word *value* does not always suggest the subjective[400].

Bohm-Bawerk was keen on striving to refute Karl Mark, but he was also interested in advancing a theory of interest based on the marginal utility of capital - a theory that introduced a comparison of present and future values. People tend, he argued, to overestimate future resources and to underestimate future wants; besides, goods available now will yield goods of higher value in the future. In light of these three reasons – the first two psychological and the third technological - people will be inclined to place a higher value on present than on future goods of the same kind and quantity, and to induce them to exchange present for future goods they are to be paid an *agio*, or premium, which equates the value of the present and future goods. This *agio* is known as interest[401].

Since the three reasons Bohm-Bawerk used to explain the emergence of interest were based on psychological and technological considerations accounting for a higher value of present as compared with future goods, Bohm-Bawerk concluded that interest is a general category and a feature characteristic of all economic systems and does not arise, as socialists argued, from the exploitation of labour under specific economic institutions. The three reasons for interest, he insisted, are still present under socialism, which cannot simply abolish the difference in the value of present and future goods. If under socialism the attempt were made to pay the labourer the undiscounted value of his product, curious results would ensue. A forester whose work would yield oak trees a hundred years hence would receive a wage several hundred times that of a baker, whose product ripens in a day. If on the other hand, both were paid at the rate of the baker, with the interest accruing to the community and redistributed by it, it would still be true just as it is of capitalist society that owners of present goods derive interest through the labour of those who are producing a future product[402].

Bohm-Bawerk's insistence that interest is a general category and not one arising from specific historical institutions was meant to combat not only the exploitation theory of the Socialists but also the views of the historical

[400] ibid. p. 616.
[401] Spiegel, p. 539.
[402] ibid., pp. 541-542

economists in Germany. With his interest theory the unity of the Austrian school's message gave way to a measure of diversity, since his contribution remained controversial even among the other founding members of the school. The diversity became still more pronounced with the latter Austrians, most of whom adhered to or magnified certain features of the Austrian tradition while shedding others[403].

13.4 The Younger Austrians

Among the Austrian-trained economists who attained prominence as the twentieth century advanced were Ludwig von Mises, Friedrich von Hayek and Joseph A. Shumpeter.

Ludwig von Mises (1881-1873) **-** Mises was born on September 29, 1881, in Lemberg, then part of the Austro-Hungarian Empire. He entered the University of Vienna in 1900, studied under Eugen Bohm-Bawek, and acquired his doctorate in law and economics I 1906. In 1909, he became economic adviser to the Austrian Chamber of Commerce, a post he held until 1934.

In 1913, following the publication of his *Theory of Money and Credit* the preceding year, he was appointed professor of economics at the University of Vienna, a prestigious but unpaid post that he also held for 20 years. His famous seminar in Vienna attracted and inspired, among others, such brilliant students as F.A.Fayek. In 1934, foreseeing the likelihood that Hitler would seize Austria, Mises left, advising his students to the same. He became professor of international economic relations at the Graduate Institute of International Studies in Geneva. In 1940, he migrated to the United States. In 1945 became a visiting professor at the Graduate School of Business Administration of New York University, a post he held until 1969. Mises has written at least 19 volumes counting only first editions, but of 46 if one counts all revised editions and foreign translations[404]. His work is large and impressive[405], but it did not receive adequate attention.

[403] ibid, p. 542.
[404] Hazlitt, Henry, Salute to Von Mises: For 92 Years He Has Fought the Good Fight, in *National Business and Financial Weekly*, Oct.1, 1973.
[405] For example, Mises was the first to integrate the theory of money with economic theory. Hazlitt; loc cit. Mises made the theory of cycles a part of the Austrian school's general theory. Haney, p. 680.

If purely theoretical work, undiluted by empiricism and free of mathematics, and methodological and political individualism were the hallmarks of the Austrian school, no one continued these tradition in a more forthright and uncompromising fashion than Mises. His criticism of socialism, an economic system that he considered impossible because it contained no rational method of pricing, was as influential and thought-provoking at its time as had been Bohm-Bawerk's a generation earlier. Like Bohm-Bawerk, but much more dogmatically so, Mises also questioned the viability of a regime of economic interventionism. His attachment to laissez faire was so strong that he refused to concede to the government a role even in the field of monetary policy, where such a role had for some time been accepted by the great majority of economists, however conservative they might be in other respects. As time went on, and especially with the expansion of public policies following the diffusion of the ideas of Keynes, the unyielding tenacity, remote from mainstream of economic thought and considered utopian by many of his contemporaries[406].

Friedrich von Hayek (1899-1992) - Among the most masterful and insightful of 20th century economists, Friedrich A. von Hayek was trained by Wieser and Bohn-Bawerk, in the Austrian tradition at Vienna, nevertheless carved a distinct spot in the economic pantheon – in some ways more different from the Austrian school than that of his friend and intellectual companion, Ludwig von Mises. At the L.S.E., Hayek was instrumental in furthering its then novel-continental bent and he was highly influential on his junior colleagues and students, until the appearance of the *General Theory* by J. M. Keyenes in 1936, when some of his protégées such as Lerner and Kaldor, drifted away. Hayek turned in 1944 to the political arena with his *Road to Serfdom,* a polemical defense of laissez faire. After spending many fruitful years at L.S.E.,Hayek joined the Committee on Social Thought of the University of Chicago in 1950. In 1962 he left for the University of Freiburg in Germany and subsequently Salzburg, where he spent his remaining years. Hayek shared the Nobel Prize with Gunnar Myrdal in 1974 in one of the more controversial and surprising awards ever made.- controversial because Myrdal had called for the abolition of the Nobel prize as a result of it been awarded to Hayek and Friedman, and surprising for, at that time, Hayek was virtually forgotten in

[406] Spiegel, p. 543.

the economics profession[407]. Interest on Hayek and his work increased after the 1974 award speech [a reiteration of his counterrevolution thesis], and it has kept on that track until today - his stock being enormously boosted by the collapse of Communism in Eastern Europe.

In his economics, while he shared the individualism and libertarianism of Mises, Hayek was more receptive to mathematical economics and was thus in a position to participate in the discussion of the technical economics of his time. In his mid-career he made notable contributions to business cycle and capital theories but in later life turned increasingly to broader questions of economic organization, doctrinal history, and economic philosophy. Hayek's contribution to business cycle theory was an *overinvestment theory*[408], in which a *capital shortage* in a twofold sense brought on the downturn: A depression ensues when investment funds cease to be readily available and thereby leave incomplete investment projects that have already been constructed but require complementary projects, the construction of which has come to a halt. Hayek's principal methodological concern was not so much with the employment of mathematics as such as with the use of natural science methods in economics, which he characterized as *scientism* and which, he thought were not fit human beings. Instead of advocating the ideal of a self-directed humanity, he invariably preferred to rely on the impersonal discipline of the market; indeed he defined theoretical economics as aiming *at explaining those uniformities in the economic activities of society, which are not the result of deliberate design but the produce of the interplay of the separate decisions of individuals and groups,* thereby excluding from it all non-market phenomena. This definition rendered in 1950, was typical of Hayek's and other Austrians' attitude to the economics of Keynes, which called for purposeful action by means of public policies[409].

Hayek's identification of economics with the study of the market economy went far beyond Menger's teaching. Menger repeatedly pointed out that

[407] Friedrich von Hayek, Biography, 1889-1992, The School of Cooperative Individualism. http://www.cooperativeindividualism.org/hayekbio2.html

[408] Mises treats cycles as the result of continuous tendency among politicians and businessmen to favour inflation of bank credit, which results in periods of low money rates, and rising prices of capital goods in comparison with consumer goods. Even after full employment banks extend more credit while it adds no new capital goods. The result is malinvestment. Finally, prices of goods other than durable goods decline and bankers cease to extend credit and the crisis develops. Haney, pp. 680-681. Hayek's ideas are found in his book: Profits, Interest & Investment (London, 1939).

[409] Spiegel, p. 543.

numerous social phenomena are not of an *organic* origin; they do nor arise as non-purposive social formations but are *pragmatic*, that is, *products of the agreement of members of society, or of positive legislation, results of the purposeful common activity of society*[410]

Joseph A. Schumpeter (1883-1950) - Schumpeter was born in Moravia, then in Austria, in 1883. He got his doctorate degree from the University of Vienna in 1906 and practiced law for several years. His interest in economics led him to attend the seminars conducted by Wieser and Bohm-Bawerk. The latter was impressed by the brilliant articles written by Schumpeter and he sought him a lecturership at the University of Vienna. Later he was a professor in one Russian University and then he joined the government as a Minister of Finance of the Austrian Republic, in 1919. In 1925 he joined the University of Bonn as a professor of economics, and by 1932 he joined the University of Harvard and stayed there until his death.

This Austrian-born Harvard professor has developed a notable theory centering on the action of enterprises as a dynamic factor, which disturbs economic equilibrium. The central idea of which Schumpeter arrived while in his twenties and which permeated his entire future work, from *The Theory of Economic Development* (1912) to *Business Cycles* (1939), and *Capitalism, Socialism and Democracy* (1942), was the importance of an entrepreneurial elite for change and growth, for the business cycle, and for the survival of capitalism. The strategic element in entrepreneurial activity was 'innovation', that is, the application of new ideas in technique and organization, which would bring about changes in the production function. Innovation would brake the circular flow of the stationary economy and generate economic development with a new equilibrium position at higher levels of income[411].

The downfall of capitalism, which Schumpeter foresaw in his *Capitalism, Socialism and Democracy* and which, would come about as a result of the success of capitalism[412], was again related to the fate of the entrepreneurial

[410] ibid., p. 544.
[411] Spiegel, pp. 544-545.
[412] To Schumpeter there are four major changes in capitalism which are the causes for its ultimate fall, and these are: the emergence of the corporate bureaucracy, replacing the typical entrepreneur as a decision maker; the elimination of small capitalist in the process of capitalist development; capitalism destroys the social groups which protect it – the businessmen cannot govern well but they come to occupy political power

elite. The overriding factor here was the ascendancy of a rationalism, which made capitalism flourish but destroyed the social fabric in which it was embedded. Enterprise became large-scale and impersonal, and with large-scale enterprise innovation, hitherto the prerogative of the captains of industry, became depersonalized and transformed into administrative routine carried on by salaried people rather than receivers of profit. Dematerialized, defunctionalised and absentee ownership does not impress and call forth moral allegiance as the vital form of property did[413].

indirectly through their money; and capitalism through its growing productivity is able to support the idle class – the elite. Bhatia, p. 377.

[413] Spiegel, p. 545.

XIV. THE MARGINALIST SCHOOL

14.1 Precursors of the Marginalist School

In the nineteenth century a host of minor writers had a clear conception of the principle that as an increasing quantity of a good is consumed, the good will yield diminishing marginal utility. None of these writers, however, had been able to elaborate in full the concept of diminishing marginal utility to apply to the solution of economic problems[414]. In retrospect, and with the benefit of hindsight the development of marginal analysis is noted in the works mathematicians such as Cournot, or an engineers working on public utility considering economic solutions to their problem such as Dupuit, or an agricultural economist such von Thunen statistical data all …*displaying some understanding of the usefulness of the marginal utility approach to the theory of demand*[415].

Antoine Augustin Cournot (1801-1877) **-** was trained in science and mathematics and spent most of his working life as university administrator. He wrote more than ten books, three in economics, the rest in mathematics (calculus and probability) and on the philosophy of science[416] and its history. Of his economics books *Recherches sur les principes mathematique de la theorie des richessess* (1838), is regarded as important. Modern theorists call it *a true gem of economic analysis* and it displays a *professional competence ... an analytical power and freshness that was breathtaking.* His work came to be respected during the period of Marshall and Walras[417].

Cournot began his economic theorising from a basis of reading Smith, Say, Ricardo, and French economists such as Canard and Walras. He began by the hypothesis that *each one seeks to derive the greatest value from his goods or from his labour.* To deduce the consequences of this hypothesis require data. The first important piece of data was hard to come by in his day, so he simply used general experience as the basis for

[414] Landreth and Colander, p. 215.
[415] ibid., p. 215
[416] Cournot's view on scientific knowledge is well known. He wrote:- …*scientific knowledge is the sign of great achievement and alone is truly capable of cumulative and indefinitely pursued progress*….
[417] Staley, p. 137.

drawing the demand curve for a commodity – the first time in the history of economics that anybody had done so. Generally the amount purchased increases when price falls, says Cournot, with things like diamonds being unimportant exceptions. The curve he assumes as continuous, monotonically decreasing, and differentiable[418].

Cournot used his maximisation hypothesis and his demand curve to analyse a variety of problems: monopoly, duopoly, perfect competition, and taxation. To show the brisk straightforwardness of the analysis, Cournot wrote the demand function as $D=F(p)$[419], total revenue as $pF(p)$, marginal revenue as $F(p)+pF(p)$, and monopoly equilibrium as determined by marginal revenue equals marginal cost. And, to make sure that this is an equilibrium where profits are at a maximum rather than a minimum, he checks the sign of the second derivative of the profit function, which has to be negative[420].

Thus, with Cournot, demand schedules and functions and downward sloping demand curves enter into the literature of economics, so do the related concepts of marginal revenue and marginal cost[421]. From the single hypothesis that each person seeks to derive the greatest possible value from his goods or his labour Cournot first develops the theory of monopoly, virtually in the same form that a century later became the standard. The monopolist who is eager to maximise his net revenue, will charge a price at which marginal revenue equals marginal cost. By gradually increasing the number of sellers, Cournot eventually arrives at the competitive case, and his discussion yields a full-fledged theory of the firm operating in various types of markets[422]. The theory of duopoly, which he develops in this context, was the first of many attempts to arrive at a determinate solution of this difficult case. In his model each of the duopolists proceed on the assumption that when he maximises his net revenue the rival will not react to this by modifying his policy regarding output which he has hitherto pursued. The reaction nevertheless takes place, and each duopolist engages in a series of successive adjustments aiming at the maximisation of his net

[418] Staley, pp.137-138.
[419] Quantity demanded is a function of price,
[420] Staley, p. 137.
[421] Spiegel, p. 509.; Staley, p. 138.
[422] Cournot had maintained a clear definition of a market. He said that … *Economists understand by the term market, not any particular market place in which things are brought and sold, but the whole of any region in which buyers and sellers are in such free intercourse with one another that the prices of the same goods tend to equality easily and quickly.*

revenue under the conditions established by the policy of the rival. The equilibrium position, which is reached when further adjustments would bring no improvement, is characterised by a price lower than that charged by a monopolist and by an output exceeding that of the monopolist. As the number of sellers increases, prices decline and output rises until the competitive case is reached.[423]

His mathematical studies led him to assume that diminishing unit costs make perfect competition impossible and led to monopoly in an industry[424]. Moreover, the employment of equations and diagrams in Cournot's work alienated many readers. However, his work had profound influence on later generations of economists, notably Walras, and Marshall[425]. When his book was published in 1838 it was considered a flop, but now it is applauded *for sheer originality and boldness of conception has no equal in the history of economic theory*[426].

Arsene-Jules-Emile Juvenal Dupuit (1804-1866) - He was a French engineer and economist who was one of the first to analyse the cost effectiveness of public utility[427]. *On the Measure of the Utility of Public Works* [which appeared in 1844], he attempted to provide a measure of the social utility of things like bridges and highways in order to know whether to advise that they be constructed. He argued that J. B. Say's measure of utility, which was the price that a person would pay was, wrong, the reason being that if a reduction in costs enables the price to fall, the measure would indicate a lower utility for the good. Dupuit's solution was to measure total utility by what a person would pay rather than go without the good. In other words, he identified the demand curve with the marginal utility curve. Total utility of the amount of goods q_1 is defined to be the area under the demand curve, 0p*n*q_1, [where *n* is a point on the demand curve corresponding to the price (p) or utility and quantity (q) levels from starting point (0), and where *P* corresponds to the highest point on the demand curve along the price level] since by charging the maximum price the consumer would pay for each unit of the good between 0 and q_1, this area would be the amount collected. If the consumer pays the price p_1 for each unit he buys, his total expenditure is

[423] Spiegel, p. 510.
[424] Haney, p. 697.
[425] Spiegel, p. 510.
[426] Blaug,, *Economic Theory in Retrospect*, 4th edition, (Cambridge, 1985), p. 317.
[427] He wrote that goods have a utility not only for the consumer, but also for each want for the satisfaction of which they are employed. This indicates that Dupuit had a good grasp the concept of final or marginal utility. Haney, p. 589.

$0p_1nq_1$. Subtracting expenditure from total utility leaves the area p_1Pn, which Dupuit called relative utility and which Marshall later called consumers' surplus. The total toll to charge for using a public work, he concluded, was the one, which provided the greatest utility together with sufficient revenue to pay the maintenance and interest on the capital[428].

Johann Heinrich von Thunen (1783-1850) **-** He was undoubtedly one of Germany's most brilliant theorists. In his general economic views he may be classified as a follower of Adam Smith. His famous work is *The Isolated State in Relation to Agricultural and Political Economy or Investigations Concerning the Influence which Grain Prices, the Richness of the Soil, and Taxes, exert upon Tillage*[429]. This work was based on detailed farm records carefully and patiently maintained over a number of years from 1826 to 1863.

He produced a masterly deductive economic thought, based in part upon careful statistical investigation; and independently developed the law of rent in an admirably clear fashion. He was the first economist to treat clearly and systematically of the influence of distance from the market upon the economics of agriculture. His method of approaching the price-determination problem plainly suggests the Austrian School's procedure; and the marginal productivity idea is clearly put, - though it is correctly connected to cost. Probably his chief claim to greatness as an economist lies in his development of the marginal analysis in determining wages and interest, and his accompanying experiments with the method of 'imputation'[430].

He applied marginal analysis to the theory of production. His treatment anticipates the principle of variable proportion and that of substitution he various labour inputs while holding capital constant, and vice versa, and underlines the impact of variations in factor and product prices on the optimum input mix. His analysis culminates in the statement that net revenue is maximised when the value of the marginal product is equal to marginal factor cost .The road to the marginal productivity theory of distribution is opened by the remark that the productivity of capital must be

[428] In some of his writings Cournot used the tool of relative utility to analyses pricing policies for private and public monopolists, how discriminatory pricing would enable an otherwise unprofitable firm to convert losses into profits, and why a small general sales tax is better than high excise taxes on a few goods. Staley, p.140
[429] Haney, p. 361; Spiegel, p. 510.
[430] Haney, p. 373.

measured by the marginal product that a constant labour input yields if combined with an increased capital input, and conversely that the productivity of labour is to be measured by the marginal product yielded by constant capital input combined with an increased labour input[431]. Although his work was widely acclaimed in his lifetime, his contribution and that of Cournot had yet to be singled out by Marshall, as men whose work he owed substantial debt. Furthermore, since his work was explained by reference to calculus and partial derivatives, these have alienated many a non-mathematically oriented economists.

In his analysis of rent von Thunen elaborated his theory by using an explicit example. A distant producer of a crop, under assumed conditions, must get say $3.00 per bushel, for it cost him that much. On the other hand, the producer near the city could market his product for much less- say at $1.00, but the latter cannot be compelled to take a lower price than the former, nor can it be expected of him. For the buyer, one bushel has as much value as another. As the gain is permanent and returns yearly, so his land yields an annual rent. The land rent of a farm arises, therefore, from the advantage, which it has in its situation and its soil over the worst farm, which produce in order to satisfy the demand. His conclusion goes opposite to that found in Ricardo's theory, in that von Thunen finding emphasises situation rather than fertility. Thus, his statement is a valuable corrective of the Ricardian formulation[432].

He emphasised that rent is no fixed amount, but varies with prices and interest. Also, he did not minimise or overlook the difference between agriculture and manufacture, and so between rent and interest. He wrote: *Agriculture differs essentially from industry in that, when pursued on different kinds of soil, the same human activity is rewarded by different production, whereas in industry the same activity and skill afford a similar labour product*[433].

Other Precursors[434] **-** There were also other precursors to the marginal school, but they have remained unknown because they were less influential in their writings, thus they were ignored. Amongst these is the British H. C. Fleeming Jenkins (1833-1885), an electrical engineer and an inventor and

[431] Spiegel, p. 511.
[432] Haney, p. 365.
[433] Quoted in Haney, p.366.
[434] This section is based on Stately, pp. 140-143.

held the chair of electrical engineering at Edinburgh University from 1868 on. He wrote three papers in economics, one on trade unions, one on *The Graphic Representation of the Laws of Supply and Demand and their Application to labour*, and one on the incidence of taxes. The article on trade unions had a footnote with equations of supply and demand; these caught Jevons's eye and he began a correspondence with Jenkin. Then Jenkin's paper on supply and demand appeared in 1870. Jevons's son, later reported that his father might well have postponed his writings on economic theory for several years had it not been for the articles by Jenkin, *which are distinctly mathematical in method and contain a number of very ingenious geometrical diagrams illustrating the laws of supply and demand.*

America's contribution to the roster of precursors was a man of even less influence. Charles Ellet, Jr. (1810-1862) was a civil engineer whose writing included mathematical analysis of the theory of discriminating monopoly and the theory of canal and railway rates. His work appeared in 1839 in his book, *An Essay on the Laws of Trade, in Reference to the Works of Internal Improvement in the United States.* In his book he used linear equations, claiming that for practical purposes this assumption is applicable. His technique essentially was to define a profits function in terms of the distances carried along feeder roads and new truck lines as well as in terms of freight charges, then to differentiate with respect to the freight charges to find the maximum profits. He did this in hypothetical situations of monopoly, of duopoly, and for goods and for passenger hauling services. Although his work for long completely ignored, Ellet provides an example of the affinity between engineering training and mathematical economics as noted in the cases of Dupuit and Jenkin, above.

14.2 Marginalist School Representatives

Introduction - The final three decades of the nineteenth century witnessed the birth of modern microeconomic theory. During this period the forging of a new set of analytical tools helped transform classical economics into neo-classical economics. The most important of these tools was the marginal analysis. Aside from its obvious usefulness, its development was significant because it initiated an appreciable increase in the use of mathematics in economic analysis. The acceptance of marginal analysis and full realisation of its importance and implications did not occur overnight,

however; they developed slowly throughout the period from 1870 to 1900. Its first notable application was to the theory of demand[435].

In 1870s there appeared a 'new' trend in economics, namely the adoption of Marginalism. Prominent names associated with this initial development are the German Gossen, the Austrian Carl Menger, the British Jevons, and the French Swiss Leon Walras. This approach was characterised by the use of mathematical tools – geometry, and differential calculus and integral calculus. Its reasoning and notation were mathematical in nature. The method of analysis was primarily deductive and abstract, though Jevons is also known for promoting the use of statistics and statistical tools.

Jevons, Menger and Walras all published books between 1871 and 1874, which influenced the development of orthodox economic theory, but their influence was not that immediate. The contribution of Carl Menger has been noted above in conjunction with the Austrian school. There were also other marginalist economists notably Edgeworth and Clark who merit discussion.

The theory of marginal utility, as it developed, brought in fundamental changes in the structure of economic theory and there emerged a system quite different from the one expounded by the classical economists. The development of Marginalism had been somewhat slow in the sense that its traces existed quite early in economic thought, but the theory did not develop as a wide spread movement on a well-prepared ground, and had to face lots of difficulties in the beginning. The difficulties were all the more because it seemed to justify the existing capitalist order and its concomitant distribution pattern. In other words, the opposition was from both the adherents of the old classical school and from the supporters of socialism. As a result, for a considerable period the point at discussion was not the theory itself but the applicability and importance of it[436].

An important deviation which marginal utility approach made from the older economics was in terms of conception of cost of production. In the classical approach, labour was taken as the cost of production and also as a measure of value. This led to many difficulties and exceptions especially on account of non-reproducible goods and price fluctuations in the market. A shift in favour of marginal utility as the final explanation of value carried

[435] Landreth and Colander, p. 213.
[436] Bhatia, p.308.

four advantages over the older approach. Firstly, the new approach was more correct. Labour, on account of variations in its quality as between different types and on account of time element creates many exceptions and problems. Moreover, the real explanation of value ought to lie in 'real' expenses of production etc. Secondly, the new theory is simpler. Thirdly, it is more general because it does not have to contend with the type of exceptions that were faced by the labour cost theory. Fourthly, the new theory is more relevant because it is directly related to wants and their satisfaction, a phenomenon that is at the root of our economic activities. On in all, the theory of marginal utility has been subjected to two types of criticisms. Firstly, it treats economics on an individualistic or atomistic basis, and secondly, it is developed in the context of hedonistic philosophy[437].

Marginalism finds its comprehensive application in Marshallian economics. There, a complete integration of the principle is achieved by explaining the demand, production, supply and their interaction through the interplay of marginal increments. Theory of exchange is brought in harmony with that of distribution. Throughout Marshallian system the decision-making process is controlled with reference to margin. And as pointed out above, the use of this tool has found an ever-expanding application in diverse fields of economic inquiry[438].

Hermann Heinrich Gossen (1810-1858) - The development of the marginal-utility analysis in value theory is commonly associated with the names of Jevons and the members of the Austrian school. But, both in the concept of the margin and in the emphasis of utility and demand, these men were anticipated. As is usually the case, there were forerunners[439].

A native of Rhineland, Gossen's life seems to be full of frustrations and failures, culminating in the lack of attention to what he expected to be. His book, *Development Laws of Exchange among Men*, published in 1854 in Brunswick was the result of twenty years of meditation. The confusion, which existed in economic doctrine, he conceived to lie in the absence of mathematical treatment: to deal scientifically with complicated forces requires mathematics[440]. Thus, he believed that he made a startling

[437] ibid., pp. 309-310.
[438] ibid., p. 310.
[439] ibid., p. 587.
[440] ibid., p. 590.

discovery and was entitled to the fame parallel to that of Copernicus in the physical laws of the universe. He tried to adapt economics to precise mathematical calculations and thought of a feasible exercise. Though he was not familiar with the term marginal utility, he very much expounded and used it. To him it was the value of the last atom. But his theory was completely based upon the law of diminishing marginal utility and the laws derived there from. The philosophy was utilitarian and hedonistic. Proceeding on the assumption of rationality according to which every one wants to maximise pleasure and minimise pain Gossen arrived at three laws/principles[441]:

The first is *the law of diminishing marginal utility* itself. He postulated that as one consumes more of a product, the marginal utility (the addition to total utility) diminishes. This process goes on till the relevant want is fully satisfied and the point of satiety is reached.

The second law is what is currently known as *the law of equi-marginal utility*, i.e., $MU_1/P_1 = MU_2/P_2 = MU_3/P_3$, etc. To maximise utility, a person must spend his money so that the last dollar spent on each good yields the same utility. This law obviously applies where the consumer is not able to satisfy all his wants fully (which we know he cannot). If money is paid for the purchase of commodities, then the marginal utilities of the commodities should be in proportion to the prices of these goods. It is through this relationship that utility is used to derive the demand curve, although Gossen himself did not take step.
The third law follows from the first two. *Since the marginal utility of a good decrease with its stock, it can have positive marginal utility only so long as its supply falls short of its demand (or need).* In case the supply is able to satisfy the want fully, the marginal utility of it will fall to zero.

Gossen divided goods into three categories or classes. The goods belonging to the first class are *those, which are able to directly yield satisfaction to the consumers*: these are consumer goods. The goods in the second class are *those, which cannot be consumed directly but are used for enjoying the other goods*. [E.g., pipes for smoking tobacco]. The third class of goods are *production goods such as machinery, land etc*., -they derive their value indirectly from the fact that they are able to produce goods, which in turn have utility. Here Gossen even develops a theory of imputation.[442]

[441] Haney, pp. 590-591; Spiegel, pp. 512-413; Bhatia, p. 303.
[442] Bhatia, p. 303.

Gossen's theory of value remained incomplete. Cost of production was not unimportant in his analysis, but utility claimed far greater attention in his scheme. He viewed cost of production as disutility, which arose on account of producing the good. Thus the marginal utility or value of the good to the consumer would be equated with the marginal disutility of its production, which may also be called the marginal production cost. In spite of numerous deficiencies in his treatment, we must note that Gossen's treatment of marginal utility was very precise and complete and he makes it the cornerstone of his theory[443].

William Stanley Jevons (1835-1882) - Far more consequential than the work of Gossen was the almost simultaneous publication in the 1870s of books by Jevons, Menger and Walras, in which the marginal principle was again applied to the behaviour of the consumer[444].

Jevons was born in Liverpool, England. He was a shy and thoughtful man, much given to introspection, and possessed a very inquiring turn of mind. He attended University College School and University College London, and in 1854 was made assayer of the mint at Sydney in Australia. Returning, he became successively lecturer and professor at Owens College, and professor at University College. His untimely death in 1882 came by drowning, and men have always regarded it as a great loss to economic thought[445].

Jevons brought into the development of English economic thought more of the spirit and discipline of pure science than any predecessor. Although he wrote several books and numerous essays here *Theory of Political Economy* published in 1871 is considered. His political economy, while treating of the wealth of nations with the purpose of teaching how the poor can be made as few as possible and all be well paid for their work, inquires how wealth may best be consumed. He gives consumption a distinct place, and puts it before production and distribution, in this departing from the practices of Mill and the Classical economists in general.

Thus wants and their satisfaction by utilities[446] are emphasised. *The most important law in the whole of political economy is the law of variety* in

[443] ibid., p. 303.
[444] Spiegel, p. 512.
[445] Haney, p. 593.
[446] Jevons uses the word *utility* to denote the abstract quality whereby an object serves our purpose. ibid., p. 594.

human wants: each separate want is soon satisfied; yet there is no end to wants. He goes on to point that utility is not inherent but that it is relative to wants, and too much of a good brings disutility. Utility decreases as the quantity increases. Thus there is a difference between total utility and degree of utility, the degree of utility of successive units decreasing while total utility increases[447].

He thus distinguishes between total and marginal utility; and calls the latter the *final degree of utility*[448], which he defined as *a ratio of the increase in total utility* (caused by the addition of the stock of goods under consideration) *to the increase in the stock of goods, itself.* He also illustrates the law of marginal utility graphically measuring 'pleasure' along the vertical axis and 'food' along the horizontal axis. Jevons also gives us the law of diminishing marginal utility in very clear patters, according to which " the final degrees of utility varies with the quantity of commodity and ultimately decreases as that quantity increases".
Jevons extends his analysis of utility by bringing in the element of time. While dividing a good between present and future consumption he finds that time element is equivalent to an element of uncertainty and thus reduces the final degrees of utility of future consumption. A process of discounting the future use of goods result, and therefore, consumers are likely to prefer present to future satisfactions. This element of discount increases with farther time horizons. This led Jevons to the theory of value, and he asserted that, "*repeated reflection and inquiry have led me to the somewhat novel opinion, that value depends entirely upon utility*". And he gave us the law that "*the ratio of exchange of any two commodities will be the reciprocal of the ratio of the final degree of utility of the quantities of commodity available after the exchange is completed*"[449].

Jevons emphasises the basic distinction between total and marginal utility and is thus able to solve the riddle of diamonds being more valuable than water. Total utility of water is infinitely more than that of diamonds, but on account of abundant supply, the marginal utility of water approaches zero. Marginal utility of diamonds remains high because of their scarcity. Since

[447] ibid., p. 595.
[448] The final degree of utility is that function upon which the whole *Theory of Economy* will be found to turn. To illustrate take water: It has no value, for we have so much of it that its final utility is zero. But let the supply run short through drought, and we begin to feel higher degree of utility, - and the value comes into being. Haney, p. 595.
[449] Bhatia, pp. 305-306.

the ratio of exchange is determined by marginal utilities, diamonds are far more valuable than water.

In his theoretical writings, Jevons' method was deductive and mathematical and indeed his conception of political economy was not dissimilar to that held by Senior, whom he cites with approval. He believed, as Gossen had believed, that economics can and should be a science, and that the mathematical method is necessary to make it so, - a necessity inherent in the measurement of pleasures and pains[450].

Leon Walras (1834-1910) - Marie-Esprit Leon Walras, was a Frenchman of Dutch ancestry. His father Antoine-August Walras was himself a pro-marginalist, having long spelled out in his early works the idea that 'subjective scarcity' was the cause of value and that mathematics held the key to the advancement of economics. He also entertained almost socialist ideas on land reform and taxation.

Although August Walras hoped that his son would continue on his ideas, it did not seem (at first) that the prospects were good. It appears that young Walras, to the disappointment of the father, was not giving enough attention to his studies. As Shumpeter[451] notes, *[Walras's] career displays the typical inability of the born thinker to master the practical problems of personal life. He was much too original to be a success at his schools.* However, in 1859 he wrote an article on intellectual property, and then went on to write a book refuting the economic doctrines of Proudhon (1860). Then he obtained a job at a newspaper, but his radical views did not stand him in good stead with its owners. He soon married and obtained an administrative job at a railway company. Then in 1861 he published two texts on taxation he had presented at a conference at Lausanne, outlining some of his more famous reformist ideas, which impressed the locals. In 1865 he resigned from his railway job and became involved with the worker cooperative movement. He took a job as the manager of a fledgling bank, which devoted itself to financing cooperatives. He also produced a study of cooperatives (1865) and soon enough became a major contributor to *Le Travail*, a newspaper associated with worker cooperatives. This affair was not to last: in 1868, the bank failed and the newspaper closed down.

[450] Haney, p. 598.
[451] Schumpeter, *History of Economic Analysis*, p. 828.

Walras had incurred much debt as a result of the bank failure and he was unemployed. Finally, in 1870, on the strength of his earlier lectures on taxation, the Swiss government invited him to a position at the Academy of Lausanne.

At Lausanne he quickly began writing his *Elements of Pure Economics,* dipping back once again on the work of Cournot and his father. In 1874, he published a summary version of his results in the *Journal des economistes*. The *Elements of Pure Economics* came soon after. His thought was undoubtedly independent. He constructed a more complete system based upon mathematical analysis, thus the establishment of the Mathematical school may be dated from Walras, for, though he was preceded by Cournot, his work was much more complete and systematic[452]. ‘
The effort to popularise the marginalist subjective theory of value in general and its mathematical, multi-market form in particular led Walras to write several articles exposing his theory. His *Theorie mathematique de la richesse sociale (1883)* collects many of these articles together. Of particular interest are his 1876 article on economics as a ‘branch of mathematics’ and his 1878 biography. His 1880 article presents his famous views on state nationalisation of land[453].

Leon Walras was slow in gaining recognition, and his fame suffered through no fault of his work, but from causes exterior to it. His fame, however, rests on his theory of marginal utility - a doctrine, which he enunciated independently, three years after Jevons and Menger[454]. Hence, he is regarded as the last of the founders of the *Marginal utility school*. In his analysis Walras stands somewhat between Jevons and Menger: like

[452] Haney, p. 599.
Walras applied techniques for treating systems of simultaneous equations that were well known in classical mechanics to the economic universe. Assuming a ‘regime of perfectly free competition’, Walras constructed a mathematical model in which productive factors products, and prices automatically adjust in equilibrium. Thus Walras tied together the theories of production, exchange, money and capital. *Encyclopaedia Britannica*, Inc. 1996.
[453] http://www.econ.jhu.edu/people/walras/walrbio.htm
[454] Jevons’ *Theory of Political Economy* (1871) was not well received when it appeared, but it was read. Menger’s *Principles of Economics* (1871) was both read and well received, at least in his own country. But Walras’s two-part *Elements of Pure Economics* (1874-77) was monstrously neglected everywhere despite his indefatigable efforts to get the book noticed. Mark Blaug, *Great Economists Before Keynes: an Introduction to the Lives and Works of One Hundred Great Economists of the Past*, Brighton: Wheatsheaf, 1997, p. 262.

Jevons, he was a hedonist in his outlook and like Menger he avoided Jevons' errors in the translation of subjective value into the prices of a competitive market.

Basing exchange-value on utility and limitation or scarcity of want-satisfying goods, Walras arrived at the doctrine of marginal utility in almost the same manner, as did Jevons. In addition, Walras held that the desire to equalise marginal utilities, according to Gossen's second law, would lead to exchange. And this desire, jointly with the quantity of goods possessed by each individual will give a determined demand and supply for each individual.

According to Walras, equilibrium in a competitive market could be achieved when the price is established such that supply is equal to demand. To illustrate this statement, Walras employed the notion of *prix crie* - a price called out by the auctioneer. If at this *prix crie* no equilibrium is reached between supply and demand, new prices will be called out again and again until equality is established. Walras went far beyond Jevons in employing a mathematical mode of exposition, and this was enough to scare off most of his contemporary readers. But whereas Jevons and Menger are now regarded as historical landmarks, rarely read purely for their own sake, posthumous appreciation of Walras's monumental achievement has grown so markedly since the 1930s that he may now be the most widely-read nineteenth century economist after Ricardo and Marx, particularly since the translation of the Elements into English in 1954[455].

Walras retired from his chair, in 1892 because of poor heath, but he is generally credited with having founded what subsequently became known, under the leadership of the Italian economist and sociologist, Vilfredo Pareto, as the *Lausanne School of Economics*[456].

[455] Blaug, Great Economists, 1997

[456] Leon Walras and Vilfredo Pareto represent the school. An important characteristic of the school was its' moving away from the subjectivism and utility by adding in the independent roles of cost, supply and price. Another basic feature was its' explicit introduction of the interdependence between various variables in the form of functional relationships. This led to another achievement of the school namely the theory of general equilibrium. This was a major achievement of the school, and it has led to advancement in economic theory in many directions, including in the use of mathematics. Use of mathematics not only made it possible to introduce a high degree of abstraction in economics and thus enable economists to put forth-new theories and interrelationships between economic variables, but also led to great strides in the advancement of applied

Gustav Cassel (1866-1945), - a Swedish engineer turned economist, contributed in the field of monetary theory (rather pure economics in the sense that he did not think it worthwhile to explore the phenomenon of value). He contributed to the exposition of the general equilibrium in his own restricted way, which was devoid of the utility, and the valuation derived from it.

Cassel rejected the marginal utility and its role. Instead he brings in the concept of scarcity of goods which give rise to the phenomenon of prices. To Cassel marginal utility cannot be measured, there is no way to estimate utility except to consider its manifestations in terms of money prices. Accordingly the task of the economist is not to probe the formation of values but only to analyse the determination of prices. The fact that values manifest themselves in terms of prices implies that we are to deal with the theory of prices instead of the theory of value.

Cassel seeks to explain economic phenomenon by a single principle of scarcity. With unlimited wants and limited supply, there is a need to exchange and price formation comes in to balance the demand and supply. And it is on this basis that he gives us his general theory of equilibrium. He assumes perfect competition and static economy.

Cassel had also discussed the theory of interest with the distinction between single and durable goods; the problem of balance of payments by putting forth the purchasing power parity theory as an explanation of the determination of the equilibrium rate of exchange.

John Bates Clark (1847-1835) - Clark was born in Providence, Rhode Island (U.S.A.) and was educated at Brown and Amherst and then went to do his graduate studies at Heidelberg and Zurich Universities. He returned and began teaching political science in 1877, and by 1895 he was appointed a professor of political science at Columbia University where he remained until his retirement in 1923.

The contributions, which made him famous, fall into two parts: the marginal productivity theory and the capital theory. His first book, *The Philosophy of Wealth* (1885) was a work of protest against so-called

economics. The growth of econometrics was largely possible due to the use of mathematical tools in economics. *Encyclopaedia Britannica*, Inc. 1996.

Ricardianism, with its premise of economic man, and its concentration on competition when really that form of economic organisation had disappeared. The book called for arbitration in labour disputes, profit sharing, and producers' cooperatives.

His second book, *The Distribution of Wealth* (1899), was completely different. For one thing, it was designed to show that the existing system of property rights provides a fair distribution of income in the sense that each man gets what he produced, that is, he gets his marginal product. This he demonstrated by being as abstract as Ricardo, focusing on the static state[457] and holding constant factors which account for dynamic change in the real world: changes in population, capital, technology, consumers' wants, and the elimination of inefficient business. Other assumptions are full employment and competition. Finally, there is the crucial law of diminishing returns, which, is held to be universal phenomenon, applicable to all factors of production.

Clark's fame, however, rests on his attempt to apply the marginal theory not only to market and production but also to distribution of income. The executive of a business, according to Clark's analysis, combined land and natural resources, capital and labour to produce a marketable product. He maintained that the remuneration which the executive would pay for each factor contributing to production would depend on their relative marginal productivity, that is, the last unit of each which he believed desirable to pay for, determined its price. If a farmer, for example, found it worthwhile to employ more labour on a given plot of land, he would keep on hiring until the marginal labour unit was reached. If farm wages, on the other hand, were high and land was cheap, Clark held that it might pay the farmer better to use more land and less labour, cultivating less intensively. A manufacturer would; likewise, substitute machinery for labour if the marginal value of the product he could obtain by employing machinery was greater than that of the labour, which it permitted him to eliminate. Similarly, low wages might deter technological improvement by making it more expensive to buy a machine than to pay wages for manual work.

[457] Clark made a clear distinction between static and dynamic economic conditions in his economic analysis insisting that the laws operative in a static economy must not be confounded with the laws governing conditions of continuous changes and adjustments. His theory states that given static conditions and assuming pure competition, natural law would operate so as to give to each factor of production an income reward exactly equal to the factor's contribution in the productive process.

Francis Ysidro Edgeworth (1825-1926) **-** Francis Y. Edgeworth was born in Ireland, and he studied languages before he was awarded a scholarship to study at Oxford in 1867 graduating in 1869. He had been called to the Bar in 1877 and three years later he was lecturing in logic at King's College, London. In 1888 he was appointed Professor of Political Economics at king's College, London and two years he was appointed to the Tooke chair of Economic Science. Later, he was appointed Drummond Professor of Political Economy at Oxford from 1891 to 1922, occupying the chair first held by Nassau Senior.

His original work on contract curves, indifference curves, and statistics was done in London, before his appointment at Oxford. In 1881, he became editor of the *Economic Journal* of the Royal Economic Society, a position he held until his death. Edgeworth did not develop his ideas in economics into larger, more systematic statement[458].

In 1881, he published *Mathematical Psychics: An Essay on the Application of Mathematics to the Moral sciences.* This work, really on economics, looks at the *Economical Calculus* and the *Utilitarian Calculus.* He formulated mathematically a capacity for happiness and capacity for work. His conclusions that women have less capacity for pleasure and for work than do men would not be popular in the 1990s[459]. In 1885 he published *Methods of Statistics,* which presented an exposition of the application and interpretation of significance tests for the comparison of means. In 1892, Edgeworth examined correlation and methods of estimating correlation coefficients in a series of papers. The first of these papers was *Correlated Averages.*

Edgeworth has made greater use of mathematics and this led his reasoning to a higher degree of abstraction. Edgeworth proceeds on the assumption that the utility, which one derives from consumption or possession of a good, is not dependent upon that good only, but also on the quantities possessed and consumed of other goods. In other words, utility is related to the consumer's entire consumption. This led him to develop the *indifference curves*. The familiar shape, in their current form they were drawn by Fisher, Auspitz and Lieben. From the indifference curve we get his famous *contract curve* in which two individuals, bartering with each other, come to

[458] Burtt, p. 271.
[459] A confirmed bachelor, he once told John M. Keynes, who was later joint editor of the *Journal* with him, that *large-scale enterprise*, such as Treatises and marriage, had never appealed to him. ibid., 271.

operate. These days, the concept of contract curve is used to depict the association between efficiency and equity dimensions of a redistribution of income between two individuals.

XV. THE INSTITUTIONAL SCHOOL

In its distaste for conventional price theory, willingness to contemplate social change and preference for the materials of history and sociology the American *Institutional School* resembled the German historical economists[460]. However, these were the only major points of similarity. What the group of protestants had in common was their opposition to the type of economics then in vogue and exemplified by the work of John. B. Clark[461] and also the Austrians, who were at the time at the height of their influence and with whom many American economists attempted to come to terms. Pure theory in general and, more specifically, the pure theory of comparative statistics as developed in the utility analysis of consumer behaviour and in the marginal productivity theory of distribution became targets against which the institutional economists launched their attacks. [462].

Institutionalism, though a native of America, was a counterpart of the historical school. The inspiration of Institutionalism may be traced partly to Auguste Comte (1798-1857), Charles Darwin and Herbert Spencer (1820-1903). However, its main exponents were Thorstein Veblen (1857-1929), John R. Common (1862-1945), Wesley C. Mitchell (1874-1948) and Gunnar Myrdal (1898 – 1987)[463].

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[460] There is thus a considerable resemblance between the American Institutionalists of 1914-1946 period, the German Historicists of the 1843-1872 period. …Both emphasise the importance of institution, and stress the principle of relativity. Both emphasise change, and evolution of some sort. Both vigorously attack the Classical economics on the ground of its dogmatic deductions and abstract and unreal assumptions, and especially its 'mechanical' individualism and self-interest motivation. Both seek realistic descriptions of human behaviour…. The difference is that historicists were largely interested in the question of logical method. They were also more ready to accept the existence of positive economic law in a provisional way, and for a given time and place. They, on the whole, had less of an idea of evolution in the Darwinian or Spencerian sense. Haney, p.722.

[461] In his book Philosophy of Wealth published in 1885 he found much to condemn in modern capitalism and yet in his book Distribution of Wealth published in 1899 he discovered in the prevailing system of distribution the materialisation of justice on earth.

[462] Spiegel, p.628.

[463]Only Veblen wanted to destroy the conventional approach by root and branch whereas the Common and Mitchell took conciliatory position. However, all of them fought conventional economics from within the academic bastion rather than as outsiders, but only Mitchell's career was an unqualifiedly distinguished one throughout and without reverses. ibid., pp. 628-640.

Darwin and Spencer had independently hit upon the theory of biological evolution; Comte had attempted to discover the general principles of society - a task, which Spencer also tried to pursue. Spencer carried his investigations into the whole field of society. Pure theory of the type in vogue those days was the principal target of attack by the institutionalists. These economists had the same critical attitude to conventional economic theory as the historical school, though some such as Veblen were also critical of the prevalent business civilisations as well. The chief aim of the institutionalists was to create a science of economics grounded in anthropology, social psychology and sociology. Apparently, institutional economics was like the historical economics, but it had its own special features that distinguished it from the historical school.

The institutionalists have quite a few things in common[464]:

i) They believed in the evolutionary nature of social, political and economic life of society. Accordingly, economic generalisations have to be specific to time and space.

ii) The need for testing the ideas by putting them to practice was recognised.

iii) They believed that not price but group behaviour should be the central theme of economics.

iv) The whole organisation of economic life including customs, habits and laws should be recognised in preference to only selected and specific motive forces.

v) There are many motives, which, though important, cannot be measured in quantitative terms.

vi) They believed in experimentation. To them there need not be any inherent tendency towards a harmony and elimination of maladjustment in economic life.

Institutionalism fought conventional economics from within. They started, like Adam Smith, with the stand that human action is motivated primarily by instincts, but while Smith includes in his list the instinct to better one's economic conditions, institutionalists ignore that and instead replace it by the institutions like habits, customs etc.. Moreover, these institutions and behaviour are themselves subject to evolutionary changes. And it is here that the two (behaviour and institutions) may get out of adjustment with each other as they evolve. Hence, the institutionalists reject laissez-faire and discuss experimentation and the problem of control. The older school of institutionalists primarily rejected value theory and claimed that man's

[464] Haney, p. 719.

actions were based not on 'rational' considerations, but on irrational instincts and habits. They did not set before themselves any goals for social reform. The newer groups of institutional economists, however, emphasise the need to control the institutions.

Gunnar Myrdal (1898 – 1987)[465]

Gunnar Myrdal was born in 1898 in Sweden. He graduated from law School Stockholm University in 1923[466] and obtained his *juris doctor* degree in economics in 1927. From 1925 to 1929 he studied for periods in Germany and Britain, followed by his first trip to the United States in 1929-1930 as a Rockfeller Fellow. During this period he also published his first books including *the Political Element in the Development of Economic Theory.* In 1933 he took the Chair of Political Economy and Public Finance at the University of Stockholm as the successor of Gustav Cassel. In addition to his teaching activities, Professor Myrdal was active in Swedish politics and he held several public posts [member of parliament, economic advisor to the Swedish legation in the USA, minister of commerce, and secretary-general of the United Nations Economic Commission for Europe (1947-1957)] before being appointed professor at the Institute for International Studies of Stockholm University in 1957. In the same year, he founded the Institute for International Economic Studies at the university and served as a member of the Directorate. He was also the Chairman of the Board of the Stockholm International Peace Research Institute [SIPRI].

Myrdal was of the opinion that our knowledge, as well as our ignorance, at any time and on every issue, tends to be opportunistically conditioned, and thus brought to deviate from the full truth. In every epoch and every problem, this opportunistic tendency operates also in our scientific work, if not critically scrutinised. He maintained that he held this view in the 1940s and that when he analysed the political element in the development of economic theory. He said that he was able to confirm this in his studies in many different fields, including during his service as Executive

[465] This section draws heavily from the Biography of Gunnar Myrdal http://www.nobel.se/economics/laureates/1974/myrdal-lecture.html

[466] He married in 1924 to Alva Myrdal [1902-1986]. Together they won the German Prize for Peace in 1970, Alva was awarded the Albert Einstein Peace Prize in 1981, and she shared the Nobel Peace Prize in 1982 for her role in disarmament.

Secretary of UN Economic Commission for Europe, responsible for operational work in relations with governments, as well as for research.

Myrdal's book *Monetary Equilibrium* (1931), which developed the economics of Wicksell, foreshadowed many aspects of Keynes's *General Theory*. He emphasised the dynamic nature of macroeconomic processes and in 1927 began the usage of the terms *ex-post* [the result after the event] and *ex-ante* [expected or intended before the event] with particular in relation to the equality of aggregate savings and investment in equilibrium. He emphasised the need to study the dynamics of macroeconomic process[467].

In 1939 the Carnegie Corporation of New York commissioned him to direct a study of the American Negro problem. The material, which he collected and interpreted, was published in 1944 as *An American Dilemma: The Negro Problem and Modern Democracy.* It was one of the first books to probe racial problems in the United States and to expose the differences between the American ideal and the reality of discrimination and segregation. It was also considered highly controversial, because it was published in an era when strict and open racial segregation was still widespread in the United States.

In 1957 he left his post as Secretary-General of the Economic Commission for Europe to direct a comprehensive study of economic trends and politics in South Asian countries for the Twentieth Century Fund, which resulted in *Asian Drama: An Inquiry into the Poverty of Nations and the Challenge of World Poverty, A World Anti-Poverty Program in Outline.* The *Asian Drama* deals with the poverty, lack of education, ill health, and underemployment in these countries; arguing that since direct economic aid from the developed countries was counterproductive, their independent development should be encouraged. He wrote as an institutional economist, i.e., he stressed the importance of the non-economic environment (political and social institutions and customs) of the country in which economic theory is being applied; without these factors being taken into account, the theory becomes irrelevant. Myrdal criticised the use of sophisticated mathematical techniques and believed that social, legal, health and educational factors were necessary for the realistic study of underdeveloped economies.

[467] Market House Books, Ltd. *Who Is Who in the Twentieth Century*, Oxford University Press, 1999.

In his *Economic Theory and Underdeveloped Regions* (1957), he argued that the economic growth in one area adversely affected the prosperity of another. Wealth and labour moves from poorer, peripheral areas to more central regions of economic growth and the industrial production of wealthy regions may well undercut the industrial output of the poorer regions. This draining of wealth and labour together with industrial decline is the backwash, or polarisation effect, and is a feature of core-periphery relationships.

Other important works include *Price Formation under Changeability* (1927); *An International Economy: Problems an Prospects* (1956); *Value in Social Theory* (1958); *Beyond The Welfare State* (1960); *Challenges to Affluence* (1963); *Objectivity in Social Research* (1969); *The Challenge of World Poverty* (1970); and *Against the Stream: Critical Essays in Economics* (1973). In 1974 he was awarded the Nobel Prize in Economic Sciences with Von Hayek.

Evaluation

The contribution of Institutionalism may be viewed from different angles. Veblen provided much insight into the working of the modern capitalist economy and added to our understanding of various economic phenomena. Mitchell was able to make a good use of the role of institutions in causing business cycles. The institutionalists were also emphatic, and rightly, that man is a bundle of irrationalities. But all this does not enable us to substitute conventional economics with an equally strong theory. A belief in the evolutionary nature of institutions does not provide us with a blueprint of the techniques by which the role of the institutions could be corrected into desired channels. The institutionalists substitute, in their framework, the economic man of the conventional economics by another who is guided by instincts. Their man is as fictitious as the economic man of the conventional economics is. One has no irrational preference and the other does not care for any rational preference. Similarly, the institutionalists talk of the struggle for survival. But how do the institutions operate in this area and what is the implication of such operation?

The institutionalists find fault with the existing institutions and by implication, seek a remedy there for. All this is done through a process of reasoning which by itself may be called deductive. And one may claim a kind of logical deficiency in their reasoning in the sense that the relation

between instincts and institutions is not quite clear. And this is further compounded by their ignoring of such established laws of economics as the law of diminishing returns and of diminishing marginal utility.

It would, however, be wrong to believe that Institutionalism emerged out of thin air, that it had no predecessors, or that it left no mark on the history of economic thought. On the contrary, Institutionalism is a kind of an offshoot, which fed upon the use of historical data and the method of induction. Use of institutions together with the historical facts had been made by various kinds of economists. The contribution of the institutionalists lies in providing a corrective factor to the stand that the historical school had taken. While the dream of the institutionalists to reconstruct economics has not been realised, the use of institutional and other factual data has come to stay. Mention may be made, among others, of Simon Kuznets, a student of Mitchell, whose monumental work on national income has earned him a *Nobel Prize.* Use of the institutional material has helped us in understanding the phenomenon of economic growth, and the required remedial steps.

XVI. THE MATHEMATICAL SCHOOL

The term mathematical school is quite misleading. The reason is that it does not represent a new set of ideas or philosophy. The use of mathematics might have been quite a novelty in the beginning, but now it has become a widely used tool of analysis. And the important thing is that basically it is a method of analysis and it does not involve any adherence to specific doctrines or principles, which distinguishes one school from another. As such it is difficult to enlist the members of the so-called mathematical school.

From the beginning of economic analysis, economists have sought methods to explain and display ideas. While some ideas produced economic analysis in purely literally style, others were supported by numerical calculations. A highly visible feature of modern economics is the suffusion of mathematical and empirical tools into the core of practically every economist's research. The quest to formalise economic theory and gauge its validly, at least tentatively, has been an ongoing concern in economics throughout the twentieth century and, most particularly, in the post World War II period[468].

In principle, literally, graphical and mathematical expressions of economic theory do not differ in any fundamental respect. But there are costs and benefits to the use of each means of expression. Beyond simple arithmetic, the most useful mathematical tool of the economist is differential calculus. Algebra, whether simple or complex, provides the economist with a wealth of tools by which to express economic theory. The combination of linear and matrix algebra provides economists with an estimation procedure and depicts production and consumption (or other) relations as being linear, or as being reducible to, or approximated by, linear relations. Thus, algebra and calculus are two general mathematical tools that have proved useful to the economist. Linear algebra and its elaborations provide an important mathematical tool that finds ready application in economic theory. Numerous early attempts to apply algebra, often in conjunction with calculus, highlight the development of economic theory in the nineteenth century. Friedrich von Wieser in his book *Natural Value* (1884), introduced a system of input-to-value equations in order to determine the productive contribution of each input[469].

[468] Ekelund and Hebert, pp. 582-583.
[469] ibid., pp. 585-588.

One of the most important applications of linear techniques has come through the development of *linear programming* by mathematicians John von Neumann and George Dantzig in the late 1940s and by economists Robert Dorfman, Paul Samuelson and Robert Solow in 1958. Linear programming is actually an offshoot of a broader mathematical technique called input-output analysis, which was invented by Wassily Leontief, a Russian-born American economist. Input-output analysis is a mathematical technique that emphasises the general interdependence of inputs and outputs of whole economies or regions[470].

The use of linear mathematical systems, as exemplified by linear programming and input-output analysis, has been supported in critical ways by the invention and development of the computer. Greater capacity and increased speed of calculations have permitted the development of highly sophisticated econometric forecasting models of the economy. The modern field of empirical economics, or econometrics, broadly speaking, is the application of mathematical and statistical methods to economic data in order to verify and improve economic theory. Its objective is both to explain and to predict economic behaviour within the context of theory. Within the limits of statistical inference, econometrics attempts to test economic theory using historical data, and to forecast economic events utilising a combination of economic theory and economic data[471].

One of the most interesting and robust tools of modern economic analysis is the technique called game theory. Von Neumann's 1928 article heralded the arrival of a new branch of mathematics known as the game theory. Game theory was applied initially to such topics as politics and military strategy, but many of its applications are of great help to economics. Although Cournot had anticipated the idea, the formal origins of the game are ascribed to John von Nuemann, a mathematician and Oskar Morgenstern, an economist, who set forth the formal theory in *The Theory of Games and Economic Behaviour,* published in 1944.

Furthermore, the nature and scope of decision theory are still current subjects. Using the utility index developed by Neumann and Morgenstern, psychologists made a number of experiments designed to test whether man behaves in a rational fashion, that is, whether he uses effective means to satisfy his wants. Their attempt has at times converged with that advocated by economists, who attempted to develop a theory elucidating the making

[470] ibid., pp. 588-592.
[471] Spiegel, pp. 649-652; Ekelund and Hebert, pp. 594-601.

of economic decisions under conditions of uncertainty[472]. The decision theory is related to game theory. Here the situations assumed are those of complete uncertainty regarding the actions that these decisions would provoke. Obviously, the theory of probability, together with the basic elements of game theory has found a good deal of use in decision theory.

There has been an increasing application of model building and mathematical applications in welfare economics and international economics. Use of mathematics is also finding an increasing favour in the fields of monetary; fiscal, employment and output policies. New methods of measuring the effectiveness of various policy steps are being found and tested and this trend has been helped by increasing availability of fiscal, monetary and other relevant data including information on national accounts, economic and functional classification of government budgets, etc.

Finally, the theory of utility invented by such writers as Jules Dupuit and W. S. Jevons provided the foundation for theoretical concepts that explain a central feature of an exchange economy: contacting. The theory of contracting that lies at the core of the economy is not mathematical tool itself, but it has become a subject to which the most sophisticated tools of modern economics has been applied[473].

[472] Spiegel, p. 652.
[473] Ekelund and Hebert, p. 598.

XVII. THE NEO-CLASSICAL SCHOOL

17.1 Introduction

Between the publication of John Stuart Mill's *Principles of Political Economy* and the appearance of the celebrated treatise, *Principles of Economics* written by Alfred Marshall, an interval of some forty years had elapsed. The latter was a lucid restatement of the whole body of economic thought.

During these four decades much had happened in the politico-economic set up of Western Europe and, particularly, in Britain, both from the doctrinal standpoint and in actual experience. The emergence of marginalism and its spread had a striking impact upon economic thinking marking a radical departure from the classical labour theory. The marginalist doctrine not only challenged the classical concept of value but was also used, by some adherents of the school, to undermine the validity of the Marxian labour theory of values.

Britain, in those years, had reached the zenith of her political power and her Empire extended to the remotes lands both in the East and the West. In this empire and, especially, in metropolitan British territory, British capitalism, was in its full flight of success. Though socialism, as a political force, had made little headway, trade unions had stirringly expanded and, as a result, working hours were shorter and wages higher. Though many social problems were still unsolved, Victorian optimism coloured socio-political ideas.

Capitalism outside Britain was also developing, French industrialism was steadily climbing up and Germany's industrialisation programme, which began under the auspices of Otto Von Bismarck's government, was in full development. Industrialisation in the Scandinavian countries, especially in Sweden, was considerably developed. Similarly, industrialisation was taking place in other parts of Western Europe, such as Holland, Belgium and Northern Italy. This industrial development was accompanied by the emergence of the working class as a political force- a force whose influence on the politico-economic set up could neither be neglected nor minimised.

The foundations of neoclassical economics were thus clearly established in England and the Continent. These distinguished contributors paved the way for the seminal and cohesive works of Alfred Marshall and Leon Walras - the twin founders of modern neoclassical analysis[474].

17.2 Alfred Marshall (1842-1924)

Alfred Marshall, son of a bank cashier, was born in Clapham, England. His father, a man of stern religious principles, destined him to go to Oxford to prepare for the Anglican ministry, which would have required him to study classical languages and literature. Instead, young Marshall preferred to go to Cambridge to study mathematics; he was one of the top honours students in his class and became a teacher of mathematics at Cambridge. Thus, he was much better trained in mathematics than either Walras or Jevons, but unlike them he did think that mathematics was the key to progress in economics. In fact, he came to economics from a conviction that knowledge of it was essential to be able to cope with the social problems of the poor, which worried him all his life, and the kind of economics he thought useful was very detailed studies of historical and contemporary factual and institutional affairs[475].

One of his pupils at Cambridge was Mary Paley, one of the few women allowed to study at Cambridge, and when he married her in 1877 he was forced to resign his fellowship under the rules prevailing at the time. He taught for five years at Bristol, a year at Oxford and then returned in 1885 to Cambridge as professor until 1908.[476]

Marshall was not one to rush into print with his ideas. However, his wife was commissioned to produce a small book *The Economics of Industry* for extension classes in 1879, to which he decided to contribute a great deal. Among his written works are: *Official Papers* (1926), a republication of his work on currency presented to a Government Commission in 1887 and 1889; *Money, Credit and Commerce* (1923); *Industry and Trade* (1919); *The Pure Theory of Foreign Trade* (1919); *The Pure Theory of Domestic*

[474] Ekelund and Hebert, p. 328.
[475] Staley, p. 178.
[476] ibid., pp. 178-179.

*values (*1919)[477]; *The Principles of Economics* (1890); and *The Economics of Industry* (1879).

Marshall began his *Principles* in 1879 and it was published in 1890, eventually going through eight editions. The book had great influence in the teaching of economics in the English speaking countries. The book reflects mathematical training, Victorian moral upbringing and his belief in the importance of realistic studies[478]. He prepared his ideas verbally putting the diagrams on footnotes with brief mathematical explanations in the appendix. A final characteristic of the book is that unlike Jevons and Walras he did not consider himself a revolutionary, but rather a developer of classical doctrine.

In the Principles, Marshall sought to reconcile the classical and modern theories of value by making use of the new thought material supplied by the subjective school building a deeper foundation, and at the same time to maintain and improve the old structure. Thus, Marshall is not to be thought of as to demolish the economics of Smith, Ricardo and Mill. On the contrary he sought to supplement it. He thought of a synthesis, first of the utility theory of the Austrians and the cost theory of the classicists; second, of the various conflicting elements in the thought of those on the whole accepted by the Classical doctrine. His synthesis was not perfect, but it is a masterpiece, and as a whole has probably never been surpassed as an explanation of economic life[479].

Marshall's Political Economy

The doctrine of maximum satisfaction, which Marshall put forward in his *Principle of Economics*[480], had its basis in Jeremy Bentham's principles of maximising utility, used by Jevons, and Marshall adopted it as his

[477] These publications were privately printed and circulated by Henry Sidgwick in order to protect Marshall's right of priority. The right of priority is a topic that has been an issue amongst historians of economic thought since the times of Marshall. [Author].
[478] Staley, p.179.
[479] Haney, pp.637-638.
[480] *Political Economy or Economics*, wrote Marshall, *is a study of mankind in the ordinary business of life; it examines that part of individual and social action, which is most closely connected with the attainment and with the use of the material requisites of well-being.* Alfred Marshall, *Principles of Economics, 8th ed. p. 1.* Quoted in Haney, p. 639.

criterion of social good. He regarded the highest social good as the arrangement, which maximised individual satisfaction. Thus, though his outlook was classical, Marshall was essentially a latter-day utilitarian - a liberal social reformer. He saw evil and strongly desired its abolition and believed that economics should not be solely descriptive but should aim at being an instrument for the services of mankind. On the other hand, Marshall rejected the notion of a primitive paradise in which everyone is happy as untrue to history.

Though Marshall admitted Malthus's and other classicist's concept that land was subject to diminishing returns, he believed that man's skill was capable to make land yield increasing returns to balance the niggardliness of nature. He criticised the classicists' subsistence wage theory and introduced, in lieu of it, a wage-concept based on *standard of comfort,* which he believed both increased efficiency of production and was made possible by increased efficiency.

Marshal also criticised the concept of the *economic man* (*homo economicus*) as too narrow, since economics deals with real men. He retained, however, the concept of the economic man for his analysis of business where pecuniary measurers are the test, no matter what actually motivated the participants.

Contributions to Economic Theory

Though Marshall's *Principles* is a general restatement of the economic doctrines of up to his time, he has made several important contributions to economic theory. Marshall was early in marginal utility field, although he was not the first. He based his theory of consumer's demand on marginal utility function in which the marginal utility of good *x* depends only on the amount of *x* consumed and not also on the amount of *y,* because the latter sort of function seems less adapted to express the every-day facts of economic life. This is called an additive utility function since the total utility of a consumer is the sum of the utilities derived from each separate good or service. And, in terms of later development, it was a cardinal utility function, in which utility is measurable. Naturally, the marginal utility was held to be diminishing. Writing the total utility function as $U_x = f(x)$, dU/dx decreases as more of x is consumed.[481]

[481] Staley, p. 181.

Another important aspect of Marshall's theory of utility is his proposition that the marginal utility of money [actually, of income rather than the stock of money held as an asset] is constant. Denote the utility of money as μ and money as m; then the marginal utility of money is $d\mu/dm$. When the consumer is buying the equilibrium quantity of x, the marginal utility per dollar spent on a unit of x is equal to the marginal utility of money. If the former is greater than the latter he should buy more x, and if less, he is buying too much x. The equilibrium condition is thus $(dU/dx)/p_x = d\mu/dm$. Now suppose the price of x falls, and hold the marginal utility of money constant. Obviously to keep the equilibrium condition the marginal utility of x has to fall, which means the consumer must buy more x! We have deducted that that the demand curve has a negative slope.

Actually, if the marginal utility of money were literally constant and the utility functions were additive, the price elasticities of demand would be unity and so would income elasticity. But Marshall, with his preference for realism[482] over vigour, would say that he meant an approximate constancy of the marginal utility of income, and proceed to discuss elasticities of either greater or less than one[483]. Although Marshall introduced the concept of *elasticity of demand,* the degree to which changes in the price of any article affect the demand for it, the word elasticity itself has been used by Cournot and hinted at by J.S.Mill in their works.

While Marshall has derived a universal rule of demand that the demand curve declines negatively throughout the whole of its length this turns out to be 'universal' only because it is true when the marginal utility of money is constant. However, there are very few practical cases where that is not approximately true to his judgement. He did notice and made one famous exceptional case: the Giffen paradox. As he explained it:[484]

[482] Marshall's concern with realism rather than formalism in economics became a hallmark of the Cambridge or neoclassical, school and led his intellectual followers to develop from his works new criticisms of the doctrine of maximum satisfaction in a competitive market system. Two criticisms became of key importance in subsequent economic thought. One was the theory of imperfect competition; the other was an analysis of the divergence of social costs from private costs. Among those who wrote on the structure of markets that fell between the two extremes of perfect competition and monopoly were Piero Sraffa, Joan Robinson and Edward Chamberlain. Burtt, p. 228.

[483] Staley, pp. 181-182.

[484] ibid., p. 182.

> *For instance, as Sir Robert Giffen has pointed out, a rise in the price of bread makes so large a drain on the resources of the poorer labouring families and raises so much the marginal utility of money for them, that they are forced to curtail their consumption of meat and the more expensive farinaceous foods; and bread being still the cheapest food which they can get and will take, they consume more, and not less of it.* [*Principles of Economics*, p. 132]

Turning to the supply side, Marshall begins by defining the *real cost* of a commodity; it is the exertions of the labour and the sacrifice in the abstinence (waiting) necessary for capital formation. Thus the real cost is a subjective psychological cost, a matter of disutility, either because labour is painful or because waiting involves a sacrifice of current consumption, and this disutility has to be paid for or else the supply of the factor of production is not forthcoming. These real costs are not of concern for the employing firm: it is interested in the money costs. Marshall warns that the correspondence between the two is not to be assumed lightly; the real costs, which are what counts when measuring the social costs of production, are not always accurately measured by money costs[485]. In fact the firms are not only interested in money costs but also interested in the least money cost for a given output. It achieves this by following the *principle of substitution*, a principle *whose applications extend over almost every field of economic inquiry*[486]. Marshall gave many illustrations of substitution at the margin, where the marginal cost of hiring a resource is equal to the value of its marginal product.

On the question of increasing and decreasing returns Marshall was not clear. One area of confusion being that diminishing returns sometimes was framed as diminishing marginal returns to successive doses of capital and/or labour applied to fixed land, and sometimes as a fall in the average product. It was Francis Y. Edgeworth who systematically and patiently sorted out the difference, pointing out that the average returns can be rising while marginal returns are falling[487].

Also, Marshall was not clear about the distinction between returns to scale, when all factors are increased and simultaneously, and the marginal returns

[485] ibid., p. 183.
[486] Marshall introduced the principle of substitution into the general theory of economics according to which a producer makes a choice of how much of the factors of production he needs to employ. *Principles*, p.341.
[487] Staley, p. 183.

to one factor when it alone is increased, holding others constant. Another important contribution of Marshall is his distinction between important economic terms such as *prime costs* (labour, power, raw materials etc.); *supplementary costs* (rent, deprecation, interest, etc,); *fixed costs* (land, machinery, building, etc.) and *variable costs* (fuel, raw materials, etc.); and his notion of *internal economics* (benefits planned and controlled within the firm's own organisation) and *external economics* (benefits or advantages available for the industry as a whole) of large-scale production. Also, Marshall identified the concept of stable as opposed to unstable equilibrium in the market. These concepts have been important contribution to economic theory.

Marshall introduced the term *quasi-rent* to apply to fixed investments. Since the capital goods in existence are in fixed supply in the short run, the return to them resembles the rent of land. In both cases the return is a surplus in the sense that the factor of production would be in existence whether the rent was paid or not. But in the long run for capital goods, the return in one industry must equal that generally attainable in the economy or the investment will not be replaced. The difference in the long-run behaviour of capital goods as compared to land is the reason why the return to land is called rent but the return to capital is *quasi-rent.*[488]

Marshall did not conclude with his price and market analysis. He discussed at length what he called *the national dividend* which refers to what we now call National Income, how the *distributive shares* in it were determine, and how their several proportions might be changed, adjusted, and modified. Furthermore, he considered the organiser or the *entrepreneur* as the central factor in the productive process. In fact, many contemporary economists, following his example, regard the role of the entrepreneur as the fourth factor of production.

Though Marshall praised the efficiency of competition, he admitted that it had bad features as well as good ones. He called for the moderation or mitigation of certain undesirable features of the economy by establishment of co-operatives or combinations. He was thus in favour of trade unionism and collectives bargaining. He also believed that private wealth was beneficial to economic development and as such it should not be abolished.

[488] ibid., p. 189.

Marshall regarded the role of the government in economic affairs as being very important. In fact, he urged governments to subsidise certain mass production industries that operate at decreasing cost as output is raised. In this way, he argued, society's total utility or satisfaction would be increased.

One of Marshall's early interests was on the subject of money, which appeared in *Money, Credit and Commerce* in 1923.there are two aspects of the Cambridge monetary theory: the cash-balances equation and the credit cycle. The cash-balances theory is a theory of the demand for money; it is based on the idea that people hold money as a convenient form of general purchasing power. Having cash on hand smoothes commercial life and personal consumption purchasing, but at the expense of foregoing an investment or at the expense of the foregone marginal utility of consumer good. The demander of money weighs the advantages against the disadvantages and decides what fraction of his income he wishes to hold as cash. The Cambridge equation is $M=kPy$ [Where, M = money, k = the desired ratio of cash to income; y = real income (Pigou's resources); and P = the price index indicating the level of prices].

When the supply of money is given – arbitrarily fixed by the government, or a function of the price level if the country is on gold standard – the price level P is determined by the equation of money supply with its demand. The major theoretical problem is what determines the size of the ratio *k.* This theory, with embellishments to take account of different values of k for holdings of cash and of bank deposits and of bank's holdings of cash as reserves against deposits, was developed by such notable British theorists as Hawtrey, Pigou, Robertson and J.M.Keynes[489].

Marshall in Retrospect

Mark Blaug describes Alfred Marshall as one of the most perplexing of all great economists. Marshall was a dominant figure in British economics from 1890s to right up the 1930s and his *Principles of Economics* still has the power to fascinate and excite the reader. He was also such a complex and contradictory economist. For example, he was a firm believer in private property and the merits of a market economy and yet he discovered some of the best arguments against the doctrine that

[489] Staley, p. 190.

free markets maximise economic welfare and always retained a sneaking sympathy for trade unions and socialism[490].

Marshall synthesised classical and neo-classical analysis of cost and utility, producing one cogent engine of economic analysis. But he was more than a synthesiser. His partial-equilibrium method was used as a glue that bound all the various branches together. The use of the conceptual time, which was at the heart of this method, was massive and original contribution to modern economic theory and policy. In addition to numerous theoretical inventions Marshall never touched a 'received' concept without extending or improving it[491].

Among many of his original contributions to economics, all of which he modestly disguised as part of the wisdom of the past, may be singled out partial-equilibrium analysis; the distinction between the market period, the short period and the long period; the improved discussion on demand curves; the idea of the price-elasticity of demand; the concept of consumer and producer surplus; the analysis of the conditions for stability of equilibrium; the distinction between increasing- and decreasing-cost industries; the distinction between internal and external economies of scale; the explicit recognition of the incompatibility of competition and long-run falling supply curves, culminating in the proposition that perfect competition does not maximise economic welfare because total welfare can always be increased by as fiscal policy of taxing increasing-cost industries to subsidise decreasing-cost industries; the concept of quasi-rents; the definition of the representative firm[492], etc.

17.3 Johann Gustav Knut Wicksell (1851-1926)

Knut Wicksell, the great Swedish economist, not only became recognised as the founder of a 'school' of economic theory, but he has also exercised such great influence on the other economists that one may say, without him economics would be different. Wicksell studied philosophy and mathematics, and obtained his degree in 1885. Thereafter, he took up economics, studying in France, Germany, Austria and England. Returning

[490] Blaug, 1997, p. 150.
[491] Ekelund and Hebert, p. 413.
[492] Blaug, 1997, p. 152.

to Sweden, he was made assistant professor at Lund in 1900, and there he occupied the chair of economics from 1904 to 1916[493].

He wrote many articles for Swedish publications[494] and some German and English journals. His major works, however, were written in the German language between 1893 and 1906. They are concentrated under five volumes: *Value, Capital and Rent* (1893); *Studies in Finance* (1896); *Interest and Prices* (1898); and two volumes of *Lectures on Political Economy* (1901 and 1906). His article on *The Influence of the Rate of Interest on Prices,* which was appeared on the *Economic Journal,* 1907, was in general area of interest. Nevertheless, *Lectures on Political Economy* contains his most important thought.

Wicksell's thought was greatly influenced by the long decline in prices and discount rates during the period 187-1895, and the discussions, which accompanied them. Thus he dwelt upon price *movements,* secular and cyclical, and tended to emphasise the part played by credit. He is a pioneer in coordinating theories of price and of interest with a theory of value of money[495].

During his years as a wandering scholar, Wicksell became acquainted with the various approaches to economics then in vogue in different European countries – the historical economics of the Germans, the pure theory in its Austrian and Walrasian variants, and the more realistic analysis of Marshall[496].

Wicksell deals with economic life in terms of marginal utility, and he makes large use of mathematical equations upon which Walras depended. He sought to synthesise the marginal productivity analysis of the Austrian school and the general price equilibrium theory of the Lausanne school – the theory that all prices are so mutually interdependent that a

[493] ibid., p. 658.
[494] He became a Neo-Malthusian in his early twenties advocating birth control at a time when this was extremely unpopular. [The advocacy for birth control was more in line with Mill rather Malthus, because the former on religious conviction did not support birth control]. In a Swedish pamphlet *The Theory of Population – its Composition and Changes*, he introduced the idea of the optimum population. This he defines as the level at which further increase leads to a reduction in prosperity, and he argued that Europe at that time had passed the optimum! Factually, European incomes have risen considerably since Wicksell's time, but his idea of optimum population has continued as a tool of welfare analysis. Staley, p. 60.
[495] ibid., pp. 658-659.
[496] Spiegel, p. 591.

mathematical process of simultaneous equations can solve the price problems[497].

Wicksell correlates his theories of value and of distribution, so that it may be said that marginal productivity occupies the centre of his system. He applied his general marginal-productivity theory under the employment all factors of production making economies from a larger-scale of production impossible. Here he considers only economically productive employment, and so avoids the problem of equilibrium at less than full employment[498].

In its broad outline what Wicksell attempted was a fusion of Austrian and Walrasian thought, in which a version of Bohm-Bawerk's capital theory, modified in line with the marginal productivity theory, was to be fitted into the general equilibrium system. In the pursuit of this attempt, Wicksell introduced numerous refinements and corrections, some of which paralleled contemporary work by other scholars, for example, his marginal productivity theory, developed one year ahead of Wicksteed, and his transformation of utility into demand functions. Wicksell, however, was virtually the only economist of note to criticise the view, advanced by some of the architects of the marginal revolution, that competitive prices denote a special optimum. Instead he pointed out that in the presence of pronounced inequalities of income an exchange between the rich and the poor might yield a larger total utility when affected at a price suitably fixed than at a competitive price, and he cautiously expanded the argument to apply to minimum wages and maximum hours of work established by legislation or by trade unions[499].

Role of Government - Wicksell favoured government intervention in a number of instances, suggested marginal cost rather than full cost pricing for public utilities and common carriers, and developed thoughts from which support for the selective nationalisation of certain industries could be drawn. He introduced the principle of marginal utility into his analysis of public finance and supplemented the conventional theory of shifting and incidence of taxation with many new insights relating to the effects of taxes on the distribution of income, to questions of social choice and

[497] Haney, p. 659.
[498] ibid., p. 659.
[499] Spiegel, p. 592

decision-making in these matters, and to the general problem of justice and taxation[500].

Capital and Interest - The main part of his thought, as judged by its influence, is the theory of capital and interest. From this springs, Wicksell's famous treatment of money rates as related to the 'natural' rate of interest, and bearing of this relation on the general price level. Capital is defined as a *coherent mass of stored-up labour and saved-up land* and the importance of time element is duly recognised. In fact, Wicksell considers the mass of capital as stratified through time, and this leads him at once into a sort of *period analysis*. Along with labour and land of one year, there function the saved-up resources [capital goods] of the preceding year. These capital goods, he assumes to be used up in the production of the current year. Therefore, he assumes, that in order to obtain the advantages of capital use, a corresponding part of the current year's resources must be saved up for the next year's capital. And so on.

Interest, in its pure form, is the *marginal productivity of waiting*. Time is the essence. More precisely, Wicksell defines interest as the difference between the marginal productivity of saved-up labour and land; and the marginal productivity of currently-used labour and land. This difference is not a mere function of time or waiting, however, for he says that current labour and land are relatively abundant, while saved-up labour and land are *not adequate in the same degree for the many purposes in which they have an advantage*[501].

Interest and Prices –The central point of this theory is the doctrine that there is a real or *natural*' rate[502] of interest, and a bank or loan rate; and that the relation between these two rates is of great importance. The 'natural' rate is the one that equalises saving and investment. It tends to equal the *expected yield* to be expected from new investment. At any time there is a normal or natural real rate. This is the rate at which the demand for loan capital and the supply of savings are equal, and also the rate, which maintains equilibrium in the goods and services markets (wages and prices will not be changing). It is relatively stable. The natural rate changes with changing expectations, inventions, and so on. The loan-rate on money loans and credit is merely the price of money determined

[500] ibid., 592.
[501] Haney, p. 660.
[502] The real rate is what Keynes called the marginal efficiency of capital. Staley, p. 224 Also, it is virtually Bohm-Bawerk's marginal productivity of capital. Haney, p. 661.

according to the Walras formula in combination with other scarce goods in a single system of simultaneous equations. It tends to equal the 'natural' rate, but may be above or below it. Suppose that we begin with the case where the loan rate equals the natural real rate, and then suppose that banks expands credit. The loan rate falls below the natural rate, with two results. Savings are discouraged, consumption is expanded, and the pressure of demand makes prices rise. At the same time profits rise so that investment spending is encouraged and once again prices and wages rise. This continues in a cumulative fashion until the increased incomes absorb all the currency for exchange purposes, leaving no cash reserves against which banks can expand credit. The loan rate will then rise back to the natural rate, reflecting the reduced supply of credit[503].

Savings and Investment – Under the Walrasian timeless system, Wicksell thought it strange that when prices fall, the fall does not merely release purchasing power and thus bring a counteracting increase in effective demand. He assumes that the spending of one individual is the income of another, so that the *aggregate* purchasing power remains the same. In this connection, no allowance is made for time lags. With this approach, he assumed that 'normal' means a condition in which income equals spending, and in which all income not spent for consumption is spent for capital (invested). Such a condition, he believed would mean a *constant price level,* which would read normal[504].

Monetary Theory – The above listed contributions were distinguished enough to earn Wicksell recognition as a thinker of substance and originality, but the contribution for which he is best remembered is the development of a monetary theory which went beyond the conventional quantity theory and with which business cycle and income theory could eventually be integrated. Wicksell took as his point of departure Tooke's income theory of prices, enunciated in 1844, according to which it is not the quantity of money but the national income designed for expenditure that determines the price level. Following Tooke in employing such macroeconomic concepts as the general demand and supply of goods, Wicksell related changes in the price level to the general monetary demand for goods exceeding, or falling short of, their supply and set the task of explaining how and why this would occur[505].

[503] Haney, p. 661-662; Spiegel, p. 592; Staley, p. 224.
[504] Haney, pp. 661-662
[505] ibid., 592.

Wicksell's break with the Classical School occurs in his treatment of money. Whereas his predecessors had seen money mainly as a medium of exchange, he gives money a more crucial role. He comes close to the later Keynesian idea of the *income approach* to the monetary theory, with its relevance to the concept of aggregate demand and the link between consumption and saving-investment elements. Wicksell saw that the market rate of interest did not always coincide with the real rate of interest, or as Marshall called it, the 'normal rate' (i.e., that which correspond with he marginal productivity of capital) and to saving-investment equilibrium.

One of Wicksell's concerns in linking monetary theory with value theory was to achieve a rate of interest, which kept prices stable. He believed that a stable price-level was the prime objective of monetary policy. In this aim, he seems to be activated more by social and moral values than by pure economic considerations, but this does not preclude him from presenting an analysis of considerable complexity and ingenuity. He saw that the movement of interest rates might, instead of achieving aggregate equilibrium, move in the opposite direction and that there were nothing necessarily self-correcting in these movements.

Appraisal - A criticism levelled against Wicksell is his attempt at synthesising the timeless economics of Walras with the time bound economics of Bohm-Bawerk. In general, he shows the weakness of *price* economics. His margins are price–determined. He virtually assumes the existence of capital, and falls back on opportunity cost – the opportunity of the lender to use his own funds. He treats interest as a price, which affects other prices, and so may be treated as a cause, rather than as a result[506].

But Knut Wicksell was a first class economist. He was eclectic, but only in the best sense. He was a true scientist, and showed his power by creating a general system of economic theory that is consistent enough to have resulted in a vigorous school of thought. Not the least result of Wicksell's thought was its influence on J.M.Keyenes, some of whose basic ideas appear to have come directly from the Swedish professor[507].

[506] Haney, p. 664
[507] ibid., p. 664.

17.4 Irving Fisher (1867-1947),

Irving Fisher spent his entire academic career, both as a student and professor at Yale University. He was wealthy because his invention of a visible card-index filing system. His research was in orthodox economic theory and statistical investigation rather than in institutionalism. He was a crusader for all kinds of reforms: for world peace, for health through diets, no cigarette smoking, and for the *compensated dollar* (the weight behind each dollar would vary so as to keep the purchasing power of the dollar constant. If prices rose, more grains of gold would be added to the definition of the dollar)[508].

Fisher was a man of diverse interests, and has been considered the greatest economist of America. His PhD dissertation was *Mathematical Investigations in the Theory of Value and Prices.* It was a study of general equilibrium involving utility theory – independent cardinal utilities, and ordinal indifference curve analysis. This work, which Paul Samuelson described as the greatest PhD dissertation ever written, has some innovations, which stuck, such as indifference curves and the use of vectors, and one, which did not.[509]

He used mathematics extensively in economics and independently he had presented a rudimentary exposition of general equilibrium. He has also contributed to the study of utility. It is to be remembered that Jevons had assumed that the utility derived by an individual from a good depended only upon that good, and that Edgeworth had extended it to include other goods also which were in possession of the consumer. Fisher extended it further by which utility of a good to an individual was also a function of the quantities of the goods consumed by all the other individuals in the market.

In his day he was better known for his work on money and index numbers. His 1911 book *The Purchasing Power of Money,* contains his version of the quantity theory of money: $MV = pQ$, where M is money, V is velocity (the number of times money turns over in a year), p is the average price, and Q the total quantity of goods purchased. Much of the book is made up of a study of the short-run effects of changing the supply of money. The long-run effect is simple: Double M and in the long-run p is doubled[510]. But in Fisher's hands the quantity theory is not mechanical but involves an

[508] Staley, pp. 208-209.
[509] ibid., 208.
[510] ibid., p. 209.

analysis of the whole macroeconomic process. In working on this theory, Fisher got deeply involved in index numbers, as the statistical verification of the quantity theory required both price and quantity indices. Fisher attempted to develop what he regarded as an ideal index number, but no index could meet all of his criteria[511].

Fisher's central contribution was his theory of interest. Originally published in 1907 as *The Rate of Interest,* the book was revised in 1930 as *The Theory of Interest,* with the subtitle *As Determined by Impatience to Spend Income and Opportunity to Invest It.* This theory is a general equilibrium supply and demand model. The productivity of capital goods is shown by the *opportunities for investment* curve that lies between the x-axis (this year's income) and y-axis (Next year's income). By sacrificing some this year's income and investing it rather, than consuming it, some return will result. At point where a budget line [whose slope is –(1+r), where r is the rate of interest] touches the curve tangentially, the consumer will arrange his investments. This combination where this year's and next year's income meet is the highest budget line that the consumer can obtain[512].

The second factor in determining interest rates is the consumer's preference between incomes today and tomorrow. This preference is shown by a set of indifference curves. The one tangent to the budget line at point F shows that in equilibrium this consumer will lend some of his today's income to someone in return for a payment, which adds to next year's income. In the market this is a supply of loans. For equilibrium to exist in the market, another consumer would have to wish to borrow that much. Otherwise the rate of interest would change[513].

17.5 Piero Sraffa (1898-1983)

Marshall's concern with decreasing cost, shared by so many students of welfare economics, set in motion still another train of thought, which in time brought to fruition theories of imperfect or monopolistic competition. The developments of these theories may be traced to Cambridge in the 1920s, where Piero Sraffa, and Joan Robinson were students[514].

[511] ibid., p. 209.
[512] ibid., p. 210.
[513] ibid., pp. 209-210
[514] Spiegel, p. 579.

Piero Sraffa, the son of a professor of commercial law was born in Turin, Italy. The young Sraffa was educated at the University of Turin, where his honours thesis *Monetary Inflation in Italy during and after the War* gained approval of his tutor. From 1921-22 Sraffa studied at LS.E, but returned to Italy to hold posts at Perugia and Cagliari. He was appointed professor of Political economy at this latter institution in 1926. His literary reputation rests on a number of important articles and two longer works: *The Works and Correspondence of David Ricardo (1951-1973)* and *Production of Commodities by means of Commodities prelude to a critique of economic theory (1960).* In 1926, Sraffa published a seminal article entitled *The Laws of Returns under Competitive Conditions.*
The gist of *The Laws of Returns under Competitive Conditions* was a plea for an analysis of the firm in terms of monopoly rather than competition. With decreasing costs widespread, the obstacle to an increase in the sales of a firm was not the threat of rising costs but the unwillingness of the market to absorb larger quantities without either price reduction or increased marketing expenses. Straffa considered this situation common enough to require adequate analytical model, and he adopted Marshall's suggestion of particular demand curves of special markets. Such particular demand curve would slope downward like the demand curve facing a monopolist. It could be so drawn because buyers would not be indifferent in their choice between the products of particular firms but would, within limits, prefer one over the others. The causes of such preference were manifold and included trademarks, names, and such special features of modelling or design on the product distinguishing it from the products of other firms. A buyer's demanded price for a product so distinguished reflected not only the valuation that he placed on this product but also the prices at which similar products could be purchased from other firms[515].

The *Production of Commodities by means of Commodities: prelude to a critique of economic theory* is concerned with the properties of an economic system, which do not depend on the scale of production or the proportion of factors. Commodities are produced by labour and by other commodities. Demand plays no role in the determination of relative prices; prices depend only on technology and on the distribution of incomes between wages and profits. Because there is one more unknown that there are equations in Sraffa's model, it is possible to take either wages or profits as given, and then to determine the relative prices and

[515] ibid., pp. 579-580.

the remaining distributive share. This differs from the neo-classical general equilibrium formulation, in which all relative commodity and factor prices are determined at the same time. Sraffa's theory appeals to people who believe that power determines people's incomes, rather than economic variables such as productivity and derived demand[516].

17.6 Joan Robinson (1900-1983)

The work of Joan Violet Robinson, who was connected with the University of Cambridge as a student and a teacher, stemmed from that of Sraffa[517] and was linked with the economists' concern about decreasing costs.

Mrs. Robinson, without doubt the most prominent woman economist, burst on the scene as a mainstream economist with her impressive *Economics of Imperfect Competition*[518], published in 1933. In this work she exhibited great skill as a microeconomic theorist in using marginal analysis to clarify and extend Marshall's hints concerning markets situated somewhere between pure competition and pure monopoly. Thus, for several years, before the publication of Keynes' *General Theory,* there was considerable interest in a Chamberlain-Robinson analysis of imperfectly competitive markets. As an important member of small group of economists from Cambridge and Oxford who helped Keynes develop the ideas that became the *General Theory*, she gained further prestige. In 1937 she published *Introduction to the Theory of Employment*, an outstanding introduction to Keynes ideas. However, Robinson's intellectual and political life manifested a movement away from orthodoxy. Her *An Essay on Marxian Economics* remains an excellent short analysis of Marx. In the 1950s she offered a new analysis of capital

[516] Staley, pp. 87-88.

[517] E.H. Chamberlin, a student and teacher at Harvard, formed his ideas without direct dependence on these strands of thought and had indeed arrived at them before the publication of Sraffa's article. However several of his teachers had participated in the discussion of Marshallian and Pigovian ideas, and their work formed a link in the transmission of thought from one Cambridge to the other. Spiegel, p. 580. In 1933, Chamberlin published his *Theory of Monopolistic Competition.*

[518] *It is a rigorous book, based in technique on the geometry of the relationships among average and marginal curves and a definition of elasticites, and it is represented in its second sentence as a 'box of tools'. It is based on the idea that 'the existence of a pe*rfect *market is likely to be extremely rare in the real world', and that all kinds of markets, including oligopolies as well as monopolistic factor markets, can be analysed with the tools of monopoly theory*. Staley, p. 216.

theory and rejected much mainstream neoclassical capital and marginal productivity theory. Moving further from orthodoxy, she authored an introductory economics text intended to convey her ideas to a broader audience, but it was not commercially successful. Indeed her drift from neoclassical and Keynesian theory had brought her into the muddy waters of heterodoxy and possibly costed her due recognition in terms of the Nobel Prize[519].

17.7 Edward H. Chamberlin (1899- 1967)

E. H. Chamberlin was born in Washington USA. He taught economics at Harvard University from 1937 to 1967, and made significant contributions to microeconomics, particularly on competition theory and consumer choice, and their connection to prices. One of the most influential economists of his time, he coined the word *product differentiation,* to describe how a supplier may be able to charge a greater amount for a product than perfect competition would allow. His works include, *Theory of Monopolistic Competition* (1933) and *Toward a More General Theory of Value* (1957).

Although Chamberlin insists that *Theory of Monopolistic Competition* is a *blending or fusion of the hitherto separate theories of monopoly and competition, whereas Mrs. Robinson left the dichotomy as sharp as ever,* almost all students of the matter have agreed with each other that in describing the structure and mechanism of equilibrium in firms and groups of firms when oligopoly and selling expenditure are absent, the two books present identical theories[520]. Thus, although both works are similar[521]; his work was more far reaching, because it attempted a thorough reconstruction of the theory of value. Chamberlin's two key concepts for blending were product differentiation and the number of sellers. Each firm has some unique features, which make its product different from those other firms – location, selling costs, the personality of the manager, etc. thus each firm has some monopoly power. And the

[519] Landreth and Colander, pp. 384-385.
[520] Staley, p. 217.
[521] Chamberlin spent the rest of his life refining this one great work and fighting against the tendency to lump the two books together as simply alternative statements of the same new macroeconomics. Mark Blaug, *Great Economists before Keynes: An Introduction to the Lives and Work of one hundred Great Economists of the past.* (Cheltenham: Edward Elgar, 1997),.p. 44.

number of firms competing against each other obviously makes a difference in the price and output of the firms.
Chamberlin's career was devoted to an attempt to formulate theory out of these concepts. After many attempts, he decided that it was not possible to cover all price theory, including competition, in terms of ordinary monopoly. Thus, in his final attempt, he emphasised oligopoly, claiming that oligopolistic elements are very general in the economic system, that economic study must increasingly be concerned with them, and that the basis for general theory to replace that of pure competition is one in which oligopoly emerges with great force[522].

[522] Staley, pp. 217-218.

XVIII. WELFARE ECONOMICS

18.1 Introduction

The term welfare is vague but in extensive use in economics. Welfare refers to the state of well-being and economic welfare refers to that part of our well being which is based upon economic variables. It is obviously a subject both in pure theory and applied economics; and therefore raises a host of questions. It is intimately connected with ethical considerations though some of its building blocks may be objective in nature[523]. Welfare economics recognises the imperfections of the economy moulded in capitalistic terms but does not advocate an intervention in or modification of the basic production relationships.

Marshall is considered the fountainhead of modern welfare economics. He provided the concepts of consumer's surplus, and producer's surplus and maintained that a policy to augment the two was desirable. He also recommended the use of fiscal policy [taxation and subsidies] for encouraging increasing returns industries and discouraging the diminishing returns ones[524].

Bentham had provided a subjective standard for estimating the aggregate satisfaction in the society. This approach obviously assumed measurability of utility and interpersonal comparisons thereof. It was also hedonistic in nature, that is, it assumed that all utility was pleasure and all disutility was pain and that while pleasure was desirable, pain was to be avoided. In Marshall the hedonistic aspect of utility was more or less dropped. Utility of a good was taken to represent only the want-satisfying power of a good or service, the measurability of utility was retained and conclusions were based upon inter-personal comparisons of utility. In the absence of information or doubts about the possibility of interpersonal comparison the assumption of equal income enjoying capacity was adopted[525].

In the next paragraphs, we will consider some leading writers in welfare economics, notably, Vilfredo Pareto, John Atkinson Hobson, Arthur Cecil Pigou, Abba P. Lerner and A. Bergson.

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[523] Bhatia, p. 415.
[524] ibid., p. 416.
[525] ibid., p. 416

18.2 Vilfredo Pareto (1848-1923)

Pareto, the renowned Italian sociologist and economist, the son of a Genoise exile[526] and a Frenchwoman, was born in Paris. He began his education in France but continued it in Italy, specialising in mathematics and classical literature. He graduated from the Polytechnic Institute in 1869 and then spent more than twenty years working as engineer and director of two Italian railway companies. He did not come to the study of economics until 1890 at the age of 42. Pareto taught economics at Laussane for only seven years, resigning in 1900 when he inherited a substantial fortune. He spent the rest of his life in Switzerland, wholly devoted to his studies and writings. Shortly before his death in 1923 he was appointed member of the Italian senate by the new government of Mussolini[527].

Pareto succeeded Walras to his Chair at the University of Lausanne in 1893 and for a long time regarded himself as a disciple of Walras. But Walras was not always happy with the younger man's social and political ideas and Pareto grew increasingly disenchanted not just with general equilibrium theory but with economics in general, choosing instead to work within the wider framework of sociology. His really formidable knowledge of mathematics and his early training as an engineer were displayed in all his major economic writings, *Cours d'économie politique* (1896-97), *Manual of Political Economy* (1906), and the important essay on *Mathematical Economics* (1911), initially prepared for the *Encyclopédie des sciences mathématiques*. He was interested in Marx as early as the 1890s but he published a powerful non-mathematical critique of socialist thought including Marxism in three volumes in *Les systemes socialistes*(1902-3). A massive work in four volumes *The Mind and Society: A Treatise on General Sociology* (1916) crowned the last decade of his active life[528].

[526] Pareto's father, the Genoese Marchese Raffaele Pareto, seems to have been a typical product of the first half of the nineteenth century – an uncompromising enemy of all governments that barred Italy's way towards national unity, and a revolutionary in this if in no other sense. Accordingly, he exiled himself to Paris where Vilfredo was born. Schumpeter, p. 113.

[527] Pareto cannot be pigeonholed. He paid court to no 'ism'. No creed or party can claim him as its own, although many creeds and parties appropriated fragments of the vast intellectual realm over which he held sway. ibid., p. 111.

[528] Blaug, *Great Economists*, pp.183-185.

Pareto's Welfare Economics

As note above, Pareto was an early adherent of the Walrasian general equilibrium, and he utilised that framework to explore and establish several areas of economic analysis, including a brilliant contribution to methodology. His welfare theory, which rests upon the maximising behaviour of individuals, adds a great deal of support to the assertion that a freely competitive system leads to an optimum of social welfare. Consumers in an attempt to maximise satisfaction are led to trade until their marginal rates of substitution are equal. Producers, in their attempt to maximise profits, are led to hire inputs up to the point where their marginal rates of technical substitution are equivalent. Pareto's demonstration, assuming that externalities do no exist, places the case for competition on a more objective basis. His emphasis upon the *effects* of maximising behaviour is in sharp contrast to the somewhat metaphysical premises of many other developers of competitive theory. Consequently, Pareto helped to hasten the acceptance of Walras's general-equilibrium analysis[529].

In the *Cours* and also in a separate memoir of 1896, Pareto published *a highly original pioneer achievement in econometrics that first established his international reputation and, under the title of Pareto's Law, created a whole literature devoted to its critical discussion.* Call N the number of income receivers who receive incomes higher than x, and A and m are two constants; then *Pareto's Law* asserts that

$$\text{Log } N = \log A + m \log x$$

Although this formulation has had its share of criticisms, especially in its interpretation, the controversies petered without yielding definite result[530].

According to Pareto, social welfare was increased by a change that made at least one individual better off, without making anybody else worse off. From this principle economists have derived the concept of *Pareto-improvement* and *Pareto-optimality*. A situation is considered Pareto-optimal if it is impossible to make further changes that satisfy the Pareto principle[531]. Actually there is not one, but many situations that fulfil this

[529] Ekelund and Hebert, p. 439-441.
[530] Schumpeter, *Ten Great Economists,* pp. 120-121.
[531] Niek Koning and Roel Jongeel, Neo-Paretian Welfare economics: misconceptions and abuses. *Wageningen Economic Papers,* Wageningen, 1997, p. 2.

condition. As a consequence economists are able to draw, as in the Edgeworth diagrams representing the standard two-input, two-product, two-consumer model, with the contract curve indicating the set of Pareto optimal allocations[532].

Pareto has come up with the concept of maximum satisfaction or ophelimity in his *Cours*. In his *Manual* he adopts a greater stance of neutrality and investigates the rules by which the society as a whole gets the maximum of wellbeing. The Pareto-optimum[533] is a point, in a general equilibrium model, from which you cannot make one consumer better off without making another one worth off[534].

Paretian welfare economics assumes that everyone is the best judge of his own interests and that this welfare depends upon economic variables only and there are no externalities involved in the process. Pareto, however, failed to recognise that his definition of optimum distribution of income admitted of a multiple (instead of a unique) solution. It also leaves out the case where the loss of losers (on account of a redistribution of income) is smaller than the gain to gainers. Of course, the latter problem involves an interpersonal comparison of utility, but it has to be faced or some other solution of it has to be found[535].

Pareto is also known for his *law* of income distribution, which indicates that the distribution of income follows a certain pattern, which cannot readily be distributed by measures of public policy. To him is also due the use of the indifference curve apparatus. His primary contribution is that of equilibrium under independence. The study of the inter relation between demand, price and income is remarkable among his secondary contributions. The theory of variable coefficients of production constitutes Pareto's greatest merit in the field of representation of the equilibrium of production. He did much to

[532] ibid., p. 3.

[533] Pareto has specified a condition of optimal or efficient allocation referred to as *Pareto condition.* By this criterion, a policy change is desirable if everyone is made better off [the weak Pareto criterion] or at least some are made better off while no one is made worse off [the strong Pareto condition]. While Pareto criterion is considered to be the common core of welfare economics, it is indeed a weak one. Per-Olov Johansen, *An Introduction to Modern Welfare Economics,* Cambridge: Cambridge University Press, 1991. pp. 10-11.

[534] *Nothing in policy matters can be pushed to the extreme. There is a line or a margin up to which the good is greater than the bad; if you cross it the bad outweighs the good*. Quoted in Hutchison, p. 267.

[535] Bhatia, p. 417.

advance the experimental part of economics. The curve of 'total receipts' is another important contribution of Pareto to economic science.

18.3 John Atkinson Hobson (1848 – 1940)

Introduction - John Atkinson Hobson, who had an ethical approach to welfare economics, whereby welfare meant *good life,* was born into a family that owned the local liberal newspaper, thus assuring him an adequate private income throughout his life. He studied classics at the University of Oxford, graduating in 1880. For some years he worked as a schoolmaster and from 1887 to 1897 he added to his income by acting as a university lecturer both in Oxford and London. Shortly after the publication of his first book *The Physiology of Industry: Being an Exposure of Certain Fallacies in Existing Theories of Economics*, which he wrote with A.F. Mummery, a businessman, he lost both posts[536].

So he moved on to London, where he was recruited by the editor of *Manchester Guardian* as its correspondent in South Africa. While reporting on the country he developed the idea that imperialism was the direct result of the expanding forces of modern capitalism. Soon after returning to England in 1900 Hobson went on a lecture tour of the country. A strong opponent of the Boer War he condemned it as a *conflict orchestrated by and fought for the preservation of finance capitalism at the expense of the working class.*

Over the next few years, Hobson published several books exploring the links between imperialism and international conflict. This included *War in South Africa* (1900) and *The Psychology of Jingoism* (1901). In his book *Imperialism* (1902), Hobson argued that imperial expansion was driven by a search for new markets and opportunities for investment overseas. These three books helped Hobson obtain international reputation and influenced political figures such as Lenin and Trotsky.

Hobson continued to write for the *Manchester Guardian* and contribute to other journals. In his book *The Industrial System: An Inquiry into Earned and Unearned Income* (1909), Hobson argued that maldistribution of income led, through oversaving and underconsumption; to unemployment

[536] Blaug, *Great Economists*, pp. 93-95.

and that the remedy lay in eradicating the *surplus* by the redistribution of income through taxation and the nationalisation of monopolies.

Hobson was opposed to Britain's involvement in the First World War and in 1914 joined the Union of Democratic Control, and served on its executive council. In his book *Towards International Government* (1914) he advocated the formation of a world body to prevent wars. However, he was highly critical of the *League of Nations,* as he believed it was little more than a *New Holy Alliance of the victors*. He was also a savage critic of the Versailles Treaty.

Although a socialist, Hobson rejected the theories of Karl Marx and favoured the reform of capitalism rather than a communist revolution. A severe critic of the Labour Government formed in 1929, he rejected the offer of peerage in 1931.

Hobson's Welfare Economics[537] - In broad perspective Hobson's heterodoxy was an attack on the accepted doctrine that laissez faire is the best policy, because markets produce a maximum of social welfare. Orthodox theory held that competitive markets will, for the most part, produce the goods that sovereign consumers desire at the lowest possible social costs. The distribution of income that flows from these markets rewards the participants according to their productivity. Furthermore, the operations of these economic forces produce a full utilisation of society's resources. Because prices are, in general, good measures of the costs incurred and the utilities produced in the economy, they are indexes of the welfare achieved by society[538].

Although he accepted some of the major assumptions of orthodox theory, he came to quite different conclusions about the adequacy of a laissez faire market economy. He found three major faults with the workings of the English economy. First, it failed to provide full employment because there existed chronic underconsumption or oversaving. Second, the distribution of income unjustly rewarded those in upper-income groups, largely because of their superior bargaining power. Third, the market is not a good measure of social costs and social utilities produced, for the entire price system is oriented toward monetary profit[539].

[537] Bhatia, pp. 417-418.
[538] Landreth and Colander, p. 350.
[539] ibid., p. 350.

Hobson was essentially a humanistic critic of current economics, rejecting exclusively materialistic definition of value. Hobson was perturbed over the ill effects which industrialisation brought in its wake. The problem with modern economy, he maintained, was that all its production decisions were market-oriented while they should have been need-oriented. To him, the performance of industry should be evaluated on the basis of its contribution to *good-life*. Unfortunately, there was no objective measure available for this test. Hobson points out that the contemporary economic science was not able to serve our purpose of estimating costs and utilities in terms of human valuation by physical and spiritual structure of the society. He provided three reasons for this state of affairs: an exaggerated stress, upon production, reflected in the terminology and method of the science, with a corresponding neglect of consumption[540]; a standard of values which has no consistent relation to human welfare; and a mechanical conception of the economic system, due to the treatment of every human action as a means to the production of non-humanly valued wealth[541].

Though material welfare depends upon improved industrial productivity, the latter does not necessarily contribute to the welfare. This is because the production can be faulty, consisting of *useless commodities and services* and constituting *unproductive surplus*. There is generally good deal of economic waste through frivolousness, vain display, drink, sham culture and the like. We can think of the competitive advertisement in modern set-up, which entails a huge waste of resources of the society, and at the same time forces labour to work harder to support an unnecessary and conspicuous consumption. Such a type of waste is certainly bad for developed economies, but worse for underdeveloped economics, which need all the resources to accelerate their economic growth[542].

On the practical side, Hobson recommended that the state should abandon its laissez-faire policy in favour of equitable distribution. True social needs and capabilities should guide production and distribution so that in the new

[540] Hobson defines saving as ‘not-consuming’, in the sense of not using up consumer goods. And, from an aggregate social point of view, he asserts that all saving necessarily means investment. Saving to him does not include mere transfers of funds by one individual to another individual. It is not mere abstention from spending on consumer goods. It necessarily means producing any sort of future goods, which are not consumed at once. Thus, oversaving us a social phenomenon. It could hardly exist outside the complex industrial society in which, every act of real saving signifies making, or causing to be made, forms of capital goods. Haney, pp. 675-676.
[541] Bhatia, p. 417.
[542] ibid., p. 418.

set-up each should contribute according to his capacity and should receive according to his needs as a consumer. Profit motive must give way to the human evaluation in production decisions. Hobson had a programme of labour laws and nationalisation of industries, which were in the nature of monopolies and public utilities. Experimental industries and artistic activities were to be left in private hands but profits were to be taxed heavily. Wages were to be raised and the state was to provide various social services like education, health services, recreation and so on. All told, therefore, Hobson's welfare economics bordered on the socialism of utopian type and the initial stages of a new scientific welfare programme[543].

18.4 Arthur Cecil Pigou (1877-1959)

Introduction - Arthur C. Pigou was born in the Isle of Wight in 1877, the son of retired army officer. He won a scholarship at an early age to the famous school Harrow, from which he won another scholarship to Cambridge, graduating in 1901. He began lecturing on economics at Cambridge in the same year, a task, which he carried on without interruption until the Second World War. In these early days he was a brilliant lecturer, and his repeated insistence to students *that it is all in Marshall* was largely responsible in the interwar years for the Marshallian orthodoxy of Cambridge economics. His early books - *Tariffs* (1903), *Industrial Peace* (1905) and *Import Duties* (1906) - do little to explain his accession in 1908 to Marshall's Chair of Economics at the early age of 30. But the *Wealth and Welfare* (1912) and *Unemployment* (1914) give a first hint of his true powers, and later *Economics of Welfare* (1920), *Essays in Applied Economics* (1923), *Industrial Fluctuations* (1927) and *A Study in Public Finance* (1928) were other major contributions. From 1927 onwards ill-health undermined the liveliness of his lecturing and the vigour of his writing. His stream of output, however never lapsed: the *Theory of Unemployment* (1933) was succeeded by *The Economics of the Stationary State* (1935), *Employment and Equilibrium* (1941) and a whole series of short popular expositions.[544]

The concept of national income can be traced to Petty, Smith, Ricardo and Mill, who employed such expressions as annual proceed and produce. With Marshall, the concept established itself in the literature of economics under the present name and it eventually became, in a different context, the focal

[543] ibid., p. 418.
[544] Blaug, *Great Economists*, pp.189-191.

point of the work of Keynes, who was Marshall's student in 1906. Pigou in his book *Wealth and Welfare*, later transformed into *The Economics of Welfare*, put the concept to good use. In Pigou's welfare economics, which was stimulated by concern about unemployment and other social problems, Marshall's national income assumed a central position. Pigou interpreted economic welfare as a subjective state of mind that was ordinarily measurable and could be related to the measuring rod of money. Its objective counterpart was the national income, certain types of changes of which were identified with changes in economic welfare. The latter would improve with an increase of the national income, with its wider diffusion, and with its greater stability[545].

In addition to the three welfare criteria of the size, distribution and stability of the national income, Pigou's welfare economics contained such novel concepts as the marginal social and marginal private net product. These concepts were designed to shed light on situations in which a private enterprise failed to be the recipient of all the returns from its operations or in which it incurred costs that were not entirely borne by it. In the case where the marginal social net product [defined as the total net yield of the marginal increment as a resource, regardless of to whom it accrued] diverged from the marginal private net product, it would frustrate the attainment of an ideal optimum output, that is, maximum national income. The attainment of the optimum required the fulfilment of two conditions. The marginal social net product would have to be equal in all uses of a resource, otherwise the transfer of resources from a use yielding a lesser marginal social net product to one in which this product was higher would raise total output. The second condition required equality of the marginal social net product with the marginal private net product. This meant that the private investor would have to receive the entire yield from an investment and he would have to bear its entire cost. Otherwise, when the marginal social net product exceeded the marginal private net product, a smaller than the optimum amount of resources would be devoted to a given use, whereas in cases of cost borne by the investor, more than optimum quantity would be invested[546].

Marshall and others had provided what may be called 'case-to-case' studies and the areas where there was a need for state intervention for improving the welfare of the society, but Pigou was the first to put the whole thing into a *system.* Those who had tried to concern themselves with the overall

[545] Spiegel, p. 572.
[546] ibid., p. 573.

performance of the economy had primarily concentrated upon changes in wealth of the society; Pigou shifted on to the consideration of nation welfare. He provided a general rule whereby the social welfare was to be judged with reference to social marginal cost and social marginal benefit. Moreover, Pigou not only analysed the problem of welfare as such, but also dealt with a number of connected problems that have a direct and indirect bearing on the welfare of the society such as unemployment, business fluctuations and the like[547].

Pigou starts with the assertion that the primary task of economics is to be a fruit-bearing discipline and for that reason it is to shun abstraction wherever it can though maintaining its analytical character. *The goal sought is to make more easy practical measures to promote welfare -- practical measures which statesmen may build upon the work of the economist*…[548]. Pigou emphasises that welfare is a very wide-range phenomenon and for practical purposes it is essential to delimit the scope of economic welfare since a *general investigation* of all the groups of causes by which welfare thus conceived may be affected would constitute a task so enormous and complicated as to be quite impracticable. Thus one may choose that portion of welfare, which can be put into quantitative terms. The one obvious instrument of measurement available in social life is money. *Hence, the range of our inquiry becomes restricted to that part of social welfare that can be brought directly or indirectly into relation with the measuring-rod of money. This part of welfare may be called economic welfare*[549]. Even this definition limiting the scope of welfare economics is not very precise since the degree of effort needed to apply measuring rod and the element of precision involved would differ from case to case. *Nevertheless, though no precise boundary between economic and non-economic welfare exists, yet the test of accessibility to a money measure serves well enough to set up a rough distinction. Economic welfare, as loosely defined by this test, is the subject matter of economic science*[550].

The important causes, which affect economic welfare, are studied with reference to three things: the size of the national dividend, the distribution of national dividend; and the variability of it. Pigou recognises that economic welfare and non-economic welfare may move in opposite

[547] ibid., p. 573
[548] A. C. Pigou, *The Economics of Welfare*, London: Macmillan and Co., Ltd., 1946, p.10
[549] ibid., p. 11.
[550] Bhatia, p. 419.

directions, but he thinks it a plausible assumption that total welfare of the society would move in the same direction as the economic welfare.

As far as the effect of variations in national dividend on economic welfare is concerned, Pigou would rather run the argument in terms of per capita income. Here also he maintains that though in general an increase in per capita national dividend goes with increased economic welfare, it need not necessarily be so. It is essential that we should keep in mind two things. Firstly, welfare being a subjective thing, it does not follow that any increase in per capita income will necessarily add to economic welfare. At the income levels, which are sufficiently low, of course, it can be safely said that an addition to per capita national dividend would lead to a corresponding increase in economic welfare also. But once per capita income exceeds a certain level, this need not be true. We may say that a principle of diminishing utility applies to income in general also. Secondly, the increase in per capita national dividend may be obtained at the cost of too high a disutility of work. The rule should be that additional national dividend should not be produced when marginal disutility from work is equated with marginal utility from income.

Regarding the division of national dividend between members of the society, Pigou made a qualified statement that a shift towards equality should enhance economic welfare. In this connection he first proceeds on the assumption that income-enjoying capacity of all the members of the society is the same. In this situation, obviously a reduction in inequalities would increase economic welfare. The solution to this problem is to redistribute income in those manners, which would not be quickly perceived by the poorer sections such as through price reductions; or the process may be completed rather slowly which would allow the poorer sections also to acquire more of income-enjoying capacity. Similarly, the government may provide more of public goods and *merit goods*, which would naturally enhance their total enjoyment[551].

Marshall's analysis of economic welfare runs in terms of partial equilibrium and partial chunks of welfare in the form of consumer's surplus and producer's surplus. In Marshall when consumer's or producer's surplus in one industry is augmented through fiscal action, the other industries in the economy are left untouched. For Pigou, however, it is not partial but total welfare, which is considered. And for this, Pigou's rule is that the allocation of resources and their utilisation in different employment should be such as

[551] Bhatia, pp. 419-420.

to lead to equality between social marginal benefit and social marginal cost. The difference between social and private concepts of these costs and benefits is the following: the money expenses or their equivalent, which a private producer has to bear at the margin, would be the marginal private cost of production. Similarly, the net addition to his total revenue in money terms would be the marginal private revenue, or benefit. On the other hand, there are many costs and benefits, which a particular productive activity brings to the society in addition to the private ones. The private producer cannot appropriate the value of those additional benefits nor is he called upon to pay for the additional disadvantages (or costs), which the society suffers due to his productive activities. The total money value of all the benefits including private ones would be the social benefits and the marginal social benefit of that activity is to be viewed with reference to that total. Similarly, marginal social cost would include, in addition to the marginal private cost, additional marginal costs being incurred by the society. In most cases, the marginal private and social costs and benefits differ. We may say that there is spill over effects that account for the divergence between the two entities. There are various examples that can illustrate this phenomenon such as the smoking chimneys or the park being maintained by a resident in a locality. Pigou identified three groups of divergences between social and private costs and benefits.

(1) There is the fact that the tenancy and ownership of certain durable instruments of production are in effect separated from each other. When the ownership of the instruments of production is of someone else, the tenant would not like to use the instruments properly or maintain them or improve them. This would therefore lead to a less than socially desirable investment.
(2) The source of divergence between social and private measures of marginal costs and benefits may be put in terms of what we now call the public goods to which the principle of exclusion does not apply. It means that in the case of these goods, the beneficiaries cannot be fully identified, and even if they are, they cannot be charged for the benefit. Similarly, in the case of certain costs or disadvantages the sufferers cannot recover damages from the producers. Actually in a number of goods, elements of externalities exist which cannot be assigned to individuals. This also calls for the institution of public undertakings and in certain cases even nationalisation to which Pigou was not averse.
(3) The third element remains vague and non-precise one. It is based upon the Marshallian distinction between increasing and decreasing returns and the need to augment the consumption of those goods whose consumption may be extended with reduced cost. Pigou also talks of the elasticity of demand that these specific goods may have and the criterions as to whether

their consumption is to be encouraged or discouraged. For example, in case of increasing returns industries the investment would be less than socially desirable if the elasticity of demand were high and if their consumption is desirable. In such a situation, these industries should be subsidised[552].

The crucial thing in Pigou's analysis is that, left to itself, the economy is likely to allocate its resources in a manner different from what the social optimum would dictate. That is, in a manner different from the one where the marginal social benefit and marginal social cost would be equated in each line of employment. These divergences ought to be remedied through fiscal and other policies.

Pigou extended his general principle of equality between social marginal cost and benefit even to the field of public finance. His principle of optimum budget or optimum state activity stresses that the public budget should ensure equality between marginal benefit to public expenditure with the marginal sacrifice which taxation imposes. This is his famous principle of maximum social advantage. Similarly, within the field of taxation, he provides the principle of least aggregate sacrifice, which is ensured by imposing the tax liability upon different members of the society such that the marginal dis-utility of taxation is the same for every taxpayer. Ordinarily, this would entail progressive tax structure[553].

Pigou also points out that our telescopic faculties are limited with the result that we are apt to provide a smaller amount of savings as a provision for future. This obviously militates against capital accumulation and in the long-run works against the necessary augmentation of national dividend and productive capacity. In other words, it works against long-term economic welfare to the extent it is dependent upon the size of national dividend.

By way of recapitulation, we may point out that Pigou's welfare economics is based upon a utilitarian moral philosophy from which hedonistic elements have been removed and where the criterion used is the 'measuring rod of money'. In Pigou, the analysis of welfare economics is based upon the cardinal measurement of utility, equal income-enjoying capacity of the members of community and the assumption that it is possible to have interpersonal comparisons of utility and that the society's welfare is the sum total of individual welfare. It may also be noted that while Marshall's

[552] ibid., p. 421.
[553] ibid., p. 422.

welfare economics is based upon partial equilibrium approach, Pigou's is that of total welfare; and while the Marshallian theory runs in 'chunks' of welfare, Pigou's is set in marginal increments. On these two accounts, Marshall's theory is far more suitable for practical policy purposes than Pigou's.

Pigou's contribution to the field of economic welfare cannot be underrated in spite of some obvious limitations from which his pioneering work suffered. Pigou's was a comprehensive system in which various aspects of the problems were discussed. He was optimistic in outlook. He made use of Marshallian concepts of national dividend and increasing and decreasing returns, but he discarded the concepts of consumer's surplus and producer's surplus in favour of a more general theory in which the overall social margins were to be equated. Moreover, Pigou's system covered the variations in national dividend and the role of labour in it. He brought in the problem of economic stability, which was as vital to economic welfare as the size, or distribution of national dividend. However, Pigou was not able to put the three dimensions of national dividend (size, distribution and variability) together to get at a final system in which the relative weights of these three dimensions were provided. He, however, emphasised the fact that the economic system as viewed by the classical and neo-classical economists was not really a friction-free phenomenon and these frictions were a major source of the need for state intervention.

18.5 Abba Ptachya Lerner (1903 -1982)

Abba P. Lerner[554] was born in Russia, raised on the London East End and worked as a machinist, a cap maker, a Hebrew teacher, a Rabbinical student and tried his hand at business before enrolling in 1929 at the London School of Economics [LSE]. It was his early association with the plethora of socialist movements prevalent in Britain in the 1920s that brought him into contact with economics. His student career was sheer brilliance. He published several first-rank papers in economic theory and still found time to launch the *Review of Economic Studies* with other colleagues (Paul Sweezy and Ursula Webb).

[554] The personal data was obtained from national Academy Press, *Biographical Memoirs (1994*), pp. 209-230, as obtained from
http://books.nap.edu/boos/0309049784/209-230.html also
http://cepa.newschool.edu/het/profiles/lerner.htm

Lerner's contributions to economic theory and policy make him one of the most influential economists of the century – although congenital inability to play academic politics ensured that he would not lead a conventional career. His initial contributions, published while he was a student, were in international trade theory and in general equilibrium theory. His 1932 article brought together the Harbeler's production possibilities frontier; Marshall's offer curves and Pareto's indifference curves into a two-sector model for international trade. This was followed up in 1934, and these have since formed the basic way of presenting international trade theory. Also, in 1934 Lerner discovered the *factor price equalisation* theorem, later rediscovered by Samuelson in 1948. His 1936 paper proved the old intuition on the symmetry of export and import taxes.

In 1934, Lerner provided one of his most remarkable papers laying out the full Pareto-optimality conditions in a general equilibrium production economy – in particular, introducing that all-important *Paretian-rule for efficiency*, i.e., that price equal marginal cost, P=MC. It was here too that Lerner presented the idea of *degree of monopoly* as being captured by the extent of deviation of price from marginal cost. Lerner stressed the importance of achieving efficiency by the P=MC rule, and that these could be achieved by socialism or free markets. He stressed that as a result, only the initial distribution of income is at the discretion of the social planner, the resulting allocation can only be as efficient as in a perfectly competitive market economy. Lerner was convince of the beauty and efficiency of the *Paretian general equilibrium* system – but sober enough to realise that it was an idealisation and rarely attained- thus, the case for socialism. However, he was not too doctrinaire about it: Lerner believed in economic democracy, the importance of consumer choice, and argued that private enterprise should take over ant particular industry in a socialist economy if it proved to be more efficient.

Lerner was opposed to waste – misallocation of resources was waste, but a far greater waste was unemployment. Perhaps of greater impact was his development of *functional finance* which argued that government policy should be designed to obtain full employment output and price stability regardless of whether it increased or decreased public debt. He was effective debunker of the ideas of the *burden of the debt* and *crowding out* arguments commonly used against deficit financing. Lerner's propositions initially shocked even Keynes himself- although he eventually embraced them fully.

His work on trade, welfare, socialism and Keynesian theory[555] culminated in his magnum opus, *The Economics of Control* (1944). The older themes were integrated and laid out fresh – particularly the P=MC efficiency rule and his principles of functional finance. In his book, new ideas were broached: he introduced the idea of counter-speculation in foreign exchange markets as government policy combined with flexible exchange rates, the Marshall-Lerner conditions for stabilityin international trade, the idea of an optimal currency area and, perhaps most famously his optimal distribution of income, which made use of the equal ignorance assumption to argue that equal distribution of income is optimal – a proposition which led to a dispute with Milton Friedman.

The optimum distribution is defined as the one, which yields maximum satisfaction to the community. There are two aspects of this division: (i) determining the share, in absolute terms, which each member of the society is to get out of given national dividend, and (ii) determining the composition of the share of each individual. The two problems are interconnected, and one cannot be solved without the other, because this involves a question of valuation of different goods and services constituting the shares of different individuals' incomes. But for the sake of clarity, Lerner segregates the two problems and solves them turn-by-turn[556].

Regarding the solution of the problem of composition of goods and services, which form the given share of an individual, Lerner makes use of the usual assumptions of independent utility of goods and services, their divisibility, trading opportunities to the individuals, applicability of diminishing marginal utility to the goods and services etc. On this basis, Lerner comes to the conclusion that optimum allocation of say, two goods between two individuals would be determined by the equality of their marginal rates of substitution for the two individuals. Extending this principle, he finds that when there are many goods and many individuals, the rate of substitution between any pair of goods should be the same for all the individuals for optimum allocation of goods between them. In case this is not so, there would be a scope for increasing the total satisfaction by reallocation of goods.

[555] A six-month stint at Cambridge in 1934-35 brought him into contact with Keynes's Cambridge Group. Subsequently he perhaps he became the first economist outside that charmed inner circle to truly grasp the meaning of Keynes's *General Theory* and as a result, became also one of the leading pioneers of the Keynesian Revolution. http://cepa.newschool.edu/het/profiles/lerner.htm

[556] Bhatia, pp. 422-423.

It is, however, in the field of absolute shares of income that Lerner makes a more relevant contribution for our purpose. It is assumed that the law of diminishing marginal utility is applicable to income of every member of the society. Accordingly, the optimum division of income would be attained when every one has the same marginal utility of income. Now if we further assume that their income-enjoying capacities are also equal, it follows that they will have identical curves of marginal utility of income. Here, therefore, optimum division of income would mean equal division of income. But in reality utility, cannot be measured in cardinal terms (though it may be agreed that diminishing marginal utility is applicable to income) and interpersonal comparisons of utility are not possible. Also income-enjoying capacities of different individuals are not the same, which means that their income-marginal-utility curves are dissimilar. Accordingly, a shift from inequality towards equality of income might entail a loss or a gain of satisfaction to the society. Lerner, however, even under these assumptions is able to show that the amount of possible loss would be smaller than the amount of possible gain whenever a move towards equality is made. He makes the plausible assumption that the probability of a gain or loss from any individual redistribution act is the same and therefore when a large number of redistribution moves are undertaken the society would end up with a greater total satisfaction from its given income[557].

Lerner has contributed substantially to economic theory, but he was always footloose as he taught at over a half-dozen universities in his career without really finding a home. However, poor a salesman, Lerner was a sharp and relentless logician, highly creative in both his theoretical and policy analysis. He treated economics as an art form and was certainly one of the greatest masters of it[558].

18.6. NEW WELFARE ECONOMICS

With the foundations of welfare economics firmly laid by Pigou, attention was directed to rid welfare economics of hedonistic elements. Paretian optimality came to the forefront in which optimum division of income is the one from which none can gain additional utility or satisfaction through redistribution without someone losing some utility in the process. This stand was further refined to bring in a distinction between efficiency and

[557] ibid., p. 423.
[558] http://cepa.newschool.edu/het/profiles/lerner.htm

equality dimension of redistribution. It would be easier to clarify this distinction between efficiency and equity by assuming that a given income is to be divided between two individuals only. When through a redistribution, the total satisfaction obtained by both individuals put together increases; we say that the new distribution is more efficient than the older one. Similarly, equity dimension would refer to the relative shares of the two individuals in the total satisfaction. It is obvious that the two dimensions are so inter-linked that it is not possible to operate along one without affecting the other also. However, the two dimensions may or may not come into conflict with each other. An economist can recommend redistribution with reference to efficiency, but equity is something to be decided on political and other grounds and the economist has nothing to do there. A question that arises is this: Can we as economists ignore the equity aspect of redistribution? The answer naturally depends upon the following: If it can be shown that the equity change can be reversed, or that equity element doesn't come into conflict with efficiency, then a redistribution on the basis of efficiency alone can be recommended[559].

Now let us take the first case namely, where it is claimed that the equity change can be reversed and therefore redistribution can be recommended on the basis of efficiency alone. We have seen that redistribution is defined to increase efficiency if it increases total satisfaction. Pareto would want that while gainers should gain, none should lose through redistribution. This stand can be modified to say that income distribution becomes more efficient if through redistribution gainers gain more than the losers lose. In that case the gainers can compensate the loser and still be better off. This entails compensation. The compensation principle was suggested by Hicks (1939) and Kaldor (1939). According to Kaldor criterion, a project is desirable if, with the project, it is hypothetically possible to redistribute income so that everyone becomes better off than without the project. In other words, gainers should be able to compensate losers, although actual compensation is not required by the compensation criteria. The Hicks criterion says that a project, i.e., what can be labelled a move from state A to state B, is desirable, if, in state A, it is impossible to redistribute incomes so that everyone is made as well off as in state B. That is, the losers should not be able to [hypothetically] bribe the gainers not to make the move from A to B, i.e., to refrain from undertaking the considered project[560]. Here, Hicks brought in the time element and pointed out over a long time, especially, the need to compensate the losers is obviated.

[559] Bhatia, p. 424.
[560] Johansson, pp. 22-23.

Unlike the Pareto principle, the compensation principle does not require actual payment of compensation. The compensation principle is stated in terms of potential compensation rather than actual compensation. If compensation wee required there would be no fundamental difference between the compensation principle and the Pareto principle[561].

Let us now come to the cases where we may ignore the question of equity instead of trying to argue whether the equity shift is to be reversed or not. Kaldor[562] here argues in favour of ignoring the equity dimension by pointing out that the economist should leave the equity decisions to other organs of the society or state such as the legislature of the country. Scitovsky thinks that Kaldor was only partially correct in making this suggestion since at the time he said it, very few governments in the world claimed to be welfare governments. These days, however, Kaldorian stand has a greater weight. Scitovsky's contribution in this field is that he lists out various cases where efficiency and equity do not come into conflict with each other. For example, when between two individuals, the first gains and the second does not lose through redistribution, it is clearly a case of positive recommendation in favour of such redistribution. The conflict arises only when a greater efficiency leads to that shift in equity, which is considered undesirable. Here, then, either there should be compensation, or the state should be able to take care of the conflict, or the very need for compensation should vanish either on account of time element or on account of randomness of numerous redistributions[563].

From the above statements, it can be surmised that the New Welfare Economics, does not say much that was new. Pigoutian welfare economics, we may say, was talking of efficiency dimension only. The new welfare economics did mention about equity, but tried to show that no attention need be paid to this dimension of redistribution. Moreover, new welfare

[561] ibid., p. 22.
[562] Nicholas Kaldor (1908-1986) was born in Hungary and educated at LSE from which he graduated in 1930. He lectured until 1947. He served in various capacities including as advisor to the Chancellor of Exchequer; Director of Research and Planning Division of the Economic Commission of Europe, a post he held for two years and as a professor of economics at Cambridge. His published works include, the *Quantitative aspects of the Full Employment Problem in Britain* (1944*); An Expenditure Tax* (1955*); Essays on Economic Stability and Growth* (1960*); Capital Accumulation and Economic Growth (1961); Essays on the Slow Rate of Growth in UK* (1966*); Conflicts in Policy Objectives (*1971); *Collected Economic Essays* (1978*) and Economics Without Equilibrium: The Okun Memorial Lectures (1985). The Penguin Dictionary of Economics*, 1998.
[563] Bhatia, pp. 424-425.

economics made this unrealistic assumption that utilities enjoyed by different individuals are dependent upon their own incomes only and are not influenced by the income shares going to others. This assumption of independence is obviously wrong. In reality, the utility function of an individual is not only dependent upon one's own income but also upon the income distribution in the rest of the society[564].

18.7. Abram Bergson (1914 -)

Abram Bergson exploded into economics with a paper written while a Harvard undergraduate, where he proposed the construction of social welfare function as a method of ranking different Pareto-optimal allocations. The Bergson-Samuelson function (as it became known) was the famous target of Arrow's *impossibility theorem*[565]. In later years, Bergson turned his hand to comparative economics – becoming one of the foremost authorities of command economics, notably that of the Soviet Union. His numerous studies on the theory and practice of socialist economies are renowned[566].

According to Bergson, the defects in the new welfare economics were to be removed in the concept of social welfare function. Bergson introduced the term 'social welfare function' in 1938[567]. He conceived of this function as the one in which the social welfare (in the sense of an aggregate and not a unanimously agreed entity) is dependent upon a number of variables. To him, it was a continuous, well behaved and a differentiable function. In this approach, it is recognised that the satisfaction, which an individual derives from his income not only depends upon his own income, but also upon the incomes going to others and the view, which this individual takes of the situation. As an example, a specific individual may be elated by the fact that

[564] ibid., p. 425.
[565] A proof that it is impossible to devise a constitution or voting system, complying with certain reasonable conditions, which can guarantee to produce a consistent set of preferences for a group from the preferences of the individuals making up the group. Arrow showed in the impossibility theorem that no system could be found that was rational and egalitarian. For example, a simple majority voting system, although giving equal weight to everybody's opinion, gives rise to the paradox of voting, allowing possibility of inconsistent ordering preferences. *The Penguin Dictionary of Economics*, 1998.
[566] http://cepa.newschool.edu/het/profiles/begson.htm
[567] Abram Bergson, A reformulation of certain aspects of welfare economics, *Quarterly Journal of Economics*, Vol. LII, pp. 310-334.

rich people having cultured tests and material amenities surround him; or he may feel dissatisfied over the fact that those who are ‘inferior’ to him do not surround him. In other words, it goes to the credit of social welfare function approach that we should take into account the fact of interdependence of utilities[568].

But the real problem arises in specifying this social welfare function and in solving it. Firstly, we must know the specific forms of individual welfare functions. Each individual welfare function will have to be identified and the relevant coefficients of all the explanatory variables will have to be specified and then a social welfare function will have to be specified by incorporating these individual welfare functions. Now apart from the fact that the individual welfare functions would be too many in number for any practicable solution, some real tough problems arise in determining the individual welfare functions. Attempts have been made to lay down the manner in which the constituents of social welfare function may be determined, but difficult problems have been faced in this connection. An important difficulty here is that of locating the true needs of the society through some kind of a voting device. The working of market mechanism cannot be used since it is the recognised failures of the market mechanism, which have led to the emergence of welfare economics. Unless, therefore, it can be ensured that income distribution is optimum and there are no frictions in the market, we cannot trust the market to guide us. Given the need to adjust income distribution nearer to optimality, it follows that we have to ascertain the true needs and preferences of the society. Apart from the fact that there are difficulties in gathering the relevant information to this effect, the 'voting pattern' may be inconclusive or contradictory.

Let us consider an example of three electors for three items. Suppose electors Ann, Bill and Caroline rank three options, defence, education and social security, as follows:

	Anne	Bill	Caroline
Defence	1	2	3
Education	2	3	1
Social Security	3	1	2

When the options, taken in pairs, are voted on, defence beats education; education beats social security but social security beats defence. In each case two of the voters rank the winning option higher than its opponent,

[568] Bhatia, p. 425.

thus ensuring its victory. As a result, the electors could either never determine which of the three options to put first, or their choice will merely depend on the order in which voting takes place – the social ranking does not possess transitivity[569]. As transitive preferences are a pre-condition for the meaningful derivation of indifference curves, the paradox is one indication that the theory of optimal behaviour for individuals cannot easily be extended to democratic societies.

Others have shown that what may be revealed, as a preference may not always be the real preference of the voters. A voter may be ignorant about the presence of certain relevant factors or those forces, which come to his notice, may misguide him. It is also well known that publicity, propaganda and selling expenses as well as the general, social, political, religious and other conditions, which surround the individuals exercising their votes, influence the preferences of individuals. Therefore, it is doubtful if there exists something like a *true* system of scale of preferences in the society that we might try to locate. Such a true system may be only a mirage and may be constantly shifting under various interacting forces including changes in knowledge, tastes, beliefs, health and similar other factors[570].

[569] A characteristic of rational preferences which holds that if a combination of goods, A, is preferred to another combination, B, and B is preferred to a third combination, C, then A must be preferred to C. Transitivity is also assumed to hold for the indifference relation between combination of goods. *The Penguin Dictionary of Economics,* 1998

[570] Bhatia, p. 426

XIX. KEYNESIAN ECONOMICS

19.1 Introduction

Economic stability and growth has been the objectives of the study of economics of all times and especially since the inception of economic classicism, which inaugurated an organized and systematic approach to this discipline of social studies. Economists have tried to understand ever since the causes of major economic phenomena, such as inequality in income distribution, price fluctuations, unemployment and economic stagnation with the entailing human miseries, and they also attempted to propose remedies.

World War I involved a hitherto unknown gigantic conflagration where countries from all continents participated. The fighting, which lasted between 1914 and 1918 gave a tremendous blow to the pre-war social thinking and particularly to the urbane complacency of the orthodox economic tradition. It disrupted international trade and payments, led governments to carry out hitherto undreamt-of interventions in economic affairs in order to concentrate on production on war necessities, and subsequently created huge government debts.

Thus, between the two World Wars, the economic environment of most industrial countries was shaken by crises of unprecedented dimensions. Unemployment mounted to record levels and was stubbornly persistent. With it came a wave of social discontent. The fabric of Western industrial communities was deeply rent by these events. Amid these symptoms of distress many reflective persons were led to ask whether or not the Marxian prognosis about the future of capitalism which had been largely written off as falsified by history in the heyday of late nineteenth century capitalism might not have been so far wrong after all.

The orthodox tradition in economic thinking was unprepared to deal with this situation. The framework of the neo-classical mentality had been organised around Say’s law, which envisaged that full employment was an economy's normal operating level, that departures from it would be minor, and that when lapses did occur the economic system itself would generate the necessary remedies. In the 1930s, this image of the functioning of an economic system seemed to be far out of touch with the realities. Not only had idleness in the labour force and in plant capacity reached unusual

proportions but there was also little to indicate that this distressing situation was correcting itself.

Despite the chasm separating the assumptions of neo-classical aggregate analysis from the world of events, economists schooled in the neo-classical tradition were not at a loss to offer an explanation for these abnormalities. The persistence of unemployment could be accounted for by rigidities within the economic system that stalled the mechanism for adjustment to full employment equilibrium. Two types of rigidities figured prominently in the discussion of the times. Perhaps the most important was the inflexibility of wages arising from the influence of trade unions. From this perspective the insistence of organised labour on strict adherence to negotiated minimum wage scales was held to be socially irresponsible. The system's normal response to unemployment, it was maintained, called for wage reductions, which would, in turn, encourage employers to hire more workers. Were it not for the obstructionism of trade unions, the economy would begin to climb the path back to full employment.

However, one of the most startling developments on the twentieth century economic analysis has been the resurgence of the classical economists' interest in aggregate economics – that is, in both monetary and macroeconomic theory. While the quantity theory of money was the means for organising economists' thoughts about the aggregate economy for well over 200 years, events both internal and external to the discipline led to the emergence of a different approach to the macro-economy in the mid-1930s. This movement, encompassing both economic theory and economic policy, took on the name of its leader, the British economist John M. Keynes. For decades, especially in the 1950s and 1960s, Keynesian thought emphasising fiscal policy dominated the economic policy of the United State and many other western nations. However, with the emergence of inflationary pressures in the 1970s and 1980s, the policy has once again shifted to money and to the reassertion of the underlying principles of the quantity theory. The theoretical to monetarism occurred even earlier. Both paradigms coexist in contemporary thought on aggregate economics[571].

[571] Ekelund and Hebert, p. 511.

19.2 John Maynard Keynes (1883-1946)[572]

The son of the Cambridge economist and logician John Neville Keynes, John Maynard Keynes was bred in British elite institutions - Eton and then King's College Cambridge. In 1906, he entered the British civil service for a little while, and then returned to Cambridge in 1909.

Three life long connections were made during this time. Firstly, he would remain a fellow of King's College, Cambridge. Secondly, he became the editor of the *Economics Journal*, in 1911, a position he would hold almost until the end of his life. He fell in love with the *Bloomsbury Group,* a collection of upper-class Edwardian aesthetes such as Virgina Wolfe, Clive Bell and Lytton Strachey, which would serve as his *life outside economics*.

His first book on *Indian Currency and Finance* (1913) was directly related to his experience at the India Office. From 1914 to 1918, Keynes was called to the UK Treasury to assist with the financing of the British war economy. He excelled at his job and the influence he gained earned him a position with the delegation to the Versailles Peace Conference in 1918. However, he was appalled at the vindictive nature of the peace settlement, and was particularly opposed to the devastating consequences of the heavy *reparation*s payments imposed on Germany. He resigned from the conference and published *The Economic Consequences of the Peace,* (1919), denouncing the Treaty of Versailles and bringing him into the spotlight.

After returning to Cambridge, Keynes published his *Treatise on Probability* (1921), where he dismantled the classical theory of probability and launched what has since become known as the *logical-relationist* theory of probability. In 1923 he published his *Tract on Monetary Reform* (1923), which was his contribution to the *Cambridge cash-balance theory* of money, then being developed by other Cambridge economists. Alfred Marshall, Arthur C. Pigou and Dennis H. Robertson.

Throughout the 1920s, Keynes remained active in public policy debates, channelled mainly through his numerous articles in the *Nation and Atheneum*, a Liberal-labour weekly magazine, which he helped to

[572] This section draws heavily from http://cepa.newschool.edu/het/profiles/Keynes.htm, and Blaug, *Great Economists,* pp. 106-109.

purchase in 1923. The best of Keynes public policy writings was collected in his *Essays in Persuasion* (1931). He was on the forefront of the battle against returning Britain to the gold standard on the pre-war parity. This led him to author two famous pieces in condemnation of laissez faire economic policy (1925, 1926). In 1929, he wrote an election pamphlet with H.D.Henderson advocating the use of public works to reduce unemployment and condemning the Treasury's fear of *budget-deficits*. In 1929, he also entered into small debate with Beril Ohlin and Jacques Tueff on German reparations problem. He also found time to marry the Russian ballerina, Lydia Lopokova in 1925.

Keynes brought out his heavy, two-volume *Treatise on Money*, which effectively set out his Wicksellian theory of the credit cycle. In it, the rudiments of the liquidity preference theory of interest are laid out and Keynes believed that it would be his *magnum opus*[573]. The *Treatise* also led to a reading group known as *the Circus*, composed of the young Cambridge economists Richard Kahn, Joan Robinson, Austin Robinson, James Meade and Piero Sraffa. This group dutifully delivered reports of their discussions, which helped Keynes to review his work.

In 1936, *The General Theory of Employment, Interest and Money* was published. Heavily anticipated, cheaply priced and propitiously timed for a world caught in the grips of the Great Depression, the *General Theory* made a splash in both academic and political circles.

Keynes's health collapsed circa 1938, and consequently dropped out of the debate ranging between his supporters and opponents around the General Theory. When World War II broke out in earnest, Keynes emerged and published his 1940 pamphlet, *How to pay for the War.* In that small tract, he identified the *inflationary gap* created by resource constraints during the war effort, and promoted the device of *compulsory saving* and rationing to prevent price inflation, proposals that were adopted in 1941.the 1940piece is notable for it provided the seeds of a theory of inflation to compliment the 'depression economics' of the *General Theory.*

[573] Unfortunately, Friedrich von Hayek, harshly reviewed Keynes's masterpiece, and this opened the Keynes-Hayek conflict, which s one battle in the Cambridge-LSE war.

During the course of the war[574], Keynes was at the Treasury and set himself to think bout the post-war economic order. In 1938, he had warmed up to Benjamin Graham's proposals for an international commodity reserve currency to replace the *gold standard.* In 1943, Keynes forged his ideas for Bancor, a proposal for an international clearing union. In consultation with the Americans, Keynes eventually relented on his idea and accepted the American *White Plan* for international equalisation fund held in the currencies of the participating nations. However, several essential aspects of Keynes's clearing union ideas were incorporated.

In 1944, Keynes led the British delegation to the international conference in Bretton Woods where the details of the system were hammered out. The American *White Plan* was accepted, countries would retain fixed exchange rates against the dollar, while the dollar itself would be matched to gold. Two institutions, the International Monetary Fund [IMF] and the World Bank [IBRD], were created to oversee the new international monetary system.

All these exhausting official missions and work taxed Keynes's already precarious health. He died in 1946, soon after arranging the guarantee of an American loan to Great Britain.

Keynes was interested in the economy of the United States and this became important about 1931 with his discussion of the causes of world depression. Then came his 1933 article on *National Self Sufficiency* in the *Yale Review*, and his open *Letter to President Roosevelt* in the *New York Times,* December, 31, 1933; and he began to write about *Mr. Roosevelt's Experiments;* the *Progress of the United States; President Roosevelt's Gold Policy,* etc., Keynes visited Franklin Delano Roosevelt, in 1934.

Two general results stand out: (1) Keynes's doctrine soon came to exercise great effect upon American policies, tending toward what he called *our own favourite experiments towards an idea, sociable republic* in the form of a nationalistic managed economy; although it was not till the recession of 1937-1938 that Roosevelt fully accepted (2) Keynes's

[574] During this period Keynes served in Britain's coalition government to advise, as did many economists of the time, on the complicated problems of taxation, finance, mobilisation of the economy and post-war planning. After the war he journeyed to the United States again and negotiated the agreement for the British credit, which preceded the famous Marshall Plan. Keynes was honoured by his government and was raised to the peerage in 1942 becoming Lord Keynes of Tilton. Haney, p. 739.

scheme of deficit-spending for stimulating recovery. Keynes's doctrines gained in influence by their adoption in the United States. (3) It may also be said that Keynes's detestation for what he called *individualistic and decadent capitalism,* and his aversion toward competition and stock market speculation were heightened.[575]

19.3 The Economics of Keynes

Between 1923 and 1931, Keynes wrote frequent articles on unemployment. At the beginning of World War II, he proposed *forced saving* to labour, as a means of avoiding higher prices, but it does not seem that he favoured a mere cutting of wages in to restore England's export trade. This theoretical background appears in his *Treatise on Money*, probably the most ambitious attempt at pure economic theory that Keynes made. In the *Treatise* he emphasised the importance of the interest rate, and argued that private saving is apt to have undesirable effects, partly because it is separate from investment decisions. Money he considered as representing all economic activity[576].

While Keynes retained certain classical doctrines, and did not attack classicism so much, his basic approach to economics was fundamentally different from that of classical economics. Classical economics was based on the price system and on a presumption in favour of the efficiency of the private enterprise. It emphasised the problem and real costs of production, including time costs. Keynes's *General Theory* differed widely in these respects[577].

One notes that his thought was in line with the writings of many recognised opponents of the classical economics – Lauderdale, Sismondi, Rae. Proudhon, Marx, and Hobson, for example. The unorthodox views of Malthus concerning under consumption are in point. Keynes appears commending and adopting ideas of contemporary radicals, and this has significance that Keynes's doctrines have in turn been commended and adopted by a good many contemporary radical thinkers including Joan Robinson and Abba P. Lerner[578].

[575] Haney, p. 739.
[576] ibid., pp. 737-738.
[577] ibid., p. 739.
[578] ibid., pp. 739-740.

Keynes's thought is similar in several respects to exactly those schools of economics, which Adam Smith undertook to overthrow, Mercantilism and Physiocracy. It has already appeared that his thought led to nationalism and the emphasis of money. The treatment of aggregate income of the nation, the circular-flow idea, and the undesirability of interrupting this by saving are to the historian, probably the most important fact is Keynes's relation to a long list of economic writers who have attacked saving as tending to cause under-consumption and depression. These have all been opponents of the classical school. Special mention is to be made of Hobson's influence. Keynes has adopted Hobson's notion that underemployment is caused by an undue exercise of the habit of saving[579].

However, Keynes's break with the classical school was over the notion of Say's law, which broadly and naively stated, holds that supply creates its own demand. A belief in Say's law was supposed to imply that unemployment, as a long-term proposition at least, was not possible. Moreover, it implies that the economy would be self-adjusting, that is, that disturbances from full-employment-full-production would be only temporary[580].

An equivalent way of stating Say's law is to say that aggregate savings will always equal investment at full employment. People generally prefer present consumption to future consumption, but given that savings is a function of the reward for saving, or a rate of interest, they can be induced to hold more assets in the form of savings if offered a positive rate of interest. Thus the classics reasoned that he amount of savings was positively related to the rate of interest.

Investment on the other hand, was negatively related to the interest rate. Because among other reasons, the productivity of given investments declined with incremental increases in investment. This declining marginal productivity of investment meant that lower rates of interest were required in order to increase the quantity of investment.

Another classical proposition that amplifies and supports Say's law is that regarding the flexibility of wages and prices in the economy. If, for some reason, the economy was sluggish in adjusting to fundamental changes in savings and investment flexible prices and wages would guarantee a

[579] ibid., p. 740.
[580] Ekelund and Hebert, p. 517.

smooth short-term adjustment. With a dearth of aggregate demand, money, wages, and prices would fall such that full employment and full production would be resumed. Workers would always be willing to take lower money wages, and entrepreneurs would be willing to accept lower prices in order to sell their goods. Any disturbance that caused unemployment and output reductions was bound to be temporary since the competition in labour and product markets would always adjust the real variables of the system to equilibrium[581]. Keynes could not agree with this.

To Keynes the equilibrium of saving and investment is not such a simple matter. Savings and investment were determined by a complex host of factors in addition to the interest rate, and there was no guarantee that the two would necessarily be equal at a level of economic activity that produced full employment[582].

Rigidities in the economy such as monopolies and labour unions thwarted the fluid movement of wages and prices, which might bring about an adjustment of the economy to full employment[583]. Keynes believed that labourers were under *wage illusion* – their behaviour was related to money wage [W] rather than to real wage [W/P], thus, they would refuse to take cuts in money wages. Since, along with the classical economists, Keynes believed that the level of employment was inversely related to the real wage rate, the refusal of labourers to take money wage cuts was a direct denial of the classical wage-rate adjustment mechanism. Keynes noted that employment does not rise by lowering wages, but real wages fall because of increased employment resulting from an increase in aggregate demand.

In the development of Keynes's thought the ideas expressed in the General Theory represented a shift from price stabilisation as the goal of public policy to the stabilisation of income and employment at high levels. In brief the contents of his ideas are as follows; the national income equals expenditures for consumption and investment. The national income at less than full employment indicates that expenditures are deficient. Among expenditures for consumption and investment, those for consumption are more passive and tend to change in respond to income. Changes in income are generated by, and reflect in a magnified

[581] ibid., pp. 517-518.
[582] ibid., pp. 518-519.
[583] ibid., p. 519.

form, changes in investment. Investment expenditure is determined by the relationship between anticipated rates if return from investment and the rate of interest. The rate of interest reflects the public preference for holding assets in the liquid form of cash. Expenditure that is deficient – inadequate to generate full employment – may be augmented by the stimulation of consumption and investment. Private investment may be supplemented by public investment, that is, by the *compensatory economy* and the partial socialisation of investment[584].

It has been noted that Keynes constructed this theory with the help of an analytical apparatus, which was impressive in its originality, coherence, and power to stimulate further thought[585].

In his definition of consumption as a function of income, C=f(Y), he was able to use its derivative, the marginal propensity to consume [δC/δY] to show that a change in investment δI, led to a multiple changes in income, δY, because the δI led to subsequent changes in consumption [C] which increased Y in turn. Formally, let

$$Y = C(Y) + I,$$

Where I is treated as a parameter. Then

$$\delta I / \delta Y = I - \delta C/\delta Y, \quad \text{or}$$
$$\delta Y / \delta I = I/(I - \delta C/\delta Y) \quad .$$

Finally,

$$\delta Y = [\, I\,(I - \delta C / \delta Y\,)]\, \delta I.$$

The second element was the multiplier[586], inversely related to saving and defined as the reciprocal of the marginal propensity to save which indicated how a change in investment generated a multiple change in consumption expenditure and therewith in income. With the propensity to consume given, the multiplier made it possible to appraise changes in income generated by changes in investment[587].

A third element in Keynes's analytical apparatus was the relationship between saving and investment, newly considered in the *General Theory*. Whereas in the *Treatise* saving and investment were defined as unequal, they were made equal by definition in the *General Theory* since both

[584] Spiegel, p. 608.
[585] ibid., p. 608.
[586] The ratio of changes in income to changes in investment [k=δY/δI],
[587] Spiegel, p. 608.

were described as the difference between income and consumption of the same period[588].

A fourth element in his analytical apparatus was the inducement to invest, reflecting the schedule of the marginal efficiency of capital, or the anticipated rate of returns on different amounts of investment, and the rate of interest. This analysis assigned a prominent place to the role of expectations, and it underlined the volatile character of investment, whose fluctuations would in turn affect income. It also coordinated the investment decision with the main body of macroeconomic theory since it interpreted this decision in terms of the maximisation principle. With a falling schedule of anticipated marginal returns as the amount of hypothetical investment increased, returns would be maximised by an investment expenditure whose marginal return was equal to the rate of interest. If a larger investment was incurred, cost would exceed the returns; if a smaller, investors would fail to exhaust the opportunities for earning returns in excess of cost[589].

In his interpretations of interest, Keynes adhered to the liquidity preference theory, a monetary theory of interest, which explains the phenomenon in terms of money as distinguished from *real* theories such as the time-preference theory or the productivity theory of interest. In this view, the rate of interest is functionally related to the amount of cash balances the public desires to hold, with a falling schedule of interest rates as the hypothetical cash balance increase. The liquidity-preference function reflects the various motives for holding cash balances – the transactions motive; the precautionary motive, and the speculative motive. The speculative motive induces people to prefer cash to securities if they expect, in contrast with the prevailing opinion of the market, the price of securities to decline or the rate of interest to rise. The monetary authorities, by equipping the people with larger cash balances, are able to bring down the interest rate down, thereby stimulating larger volume of investments. The *liquidity trap* puts a limit on this opportunity, however, because once the interest rate has declined to the very low level, a further increase in cash balance may fail to reduce it further. At this low level, holders of cash believe that only an increase in interest rates or a decline

[588] It may be noted that many preferred to have the earlier formulation of the *Treatise.* For example, The Stockholm School preferred a distinction to be made between *ex ante* or planned saving [the difference between consumption in one period and income in the preceding period] and *ex post* or realised saving [which might fall short of or exceed the investment]. ibid., pp. 608-609.
[589] ibid., p. 609.

in security prices can be expected, and they are willing to sell securities to the monetary authorities at the prevailing prices so that the interest rate will remain what it is. Hence, a purely monetary principle of coping with a depression may be abortive, and recourse must be had to fiscal policy-public works or tax reductions.

19.4 Further developments in Keynesian Economics

In the decade following the publication of the *General Theory* much work was done to elaborate and refine the ideas of Keynes. Considerable attention was given to the consumption function. The broad aggregate of consumption expenditures was broken up, and significant differences were discovered in the relationship between income and consumption expenditures for durable and non-durable goods[590].

Apart from this, new variables were introduced to shed light on consumer behaviour. For example, it was discovered that consumption expenditure was not only related to current income but also to income earned in the past. This work, which was carried out by James S. Duesenberry and Franco Modigliani, who developed their ideas independently during the late 1940s, was paralleled by Milton Friedman's *permanent income* hypothesis[591].

Keynes's analysis in the *General Theory* did not include a theory of distribution, but it provided the starting point for such a theory as developed by Nicholas Kaldor[592]. This theory demonstrated that under certain assumptions the share of profits in the national income was determined by the ratio of investment to output and that under still more restrictive assumptions – zero marginal propensity to save on the part of wage earners – profits equalled the sum of investment and of

[590] ibid, p. 610

[591] In *A Theory of the Consumption Functions* (1957), Friedman distinguished between income considered as transitory and income considered as permanent by the householders, and he attempted to demonstrate that consumer spending mainly reflects permanent income, whereas transitory income is saved. Quoted in Spiegel, p. 610.

[592] This economist who has been associated with the University of Cambridge, had developed the *compensation principle* (1939), according to which a policy adversely affecting the income of some citizens could be justified, provided the policy resulted in an increase in income elsewhere in the economy sufficient to compensate those adversely affected. Spiegel, p.576.

consumption by the receivers of property income, with wages constituting as a residue. The gist of this macroeconomic theory of distribution could be expressed as: *capitalists earn what they spend, and workers spend what they earn.*

In the further development of the multiplier concept, several variants came to be distinguished, and the application of the concept also proved fruitful in the field of international economics. The propensity to import linked changes in imports to changes in income, and the export multiplier related changes in exports to changes in income. Ways were found to demonstrate the interaction between the multiplier and acceleration principle, which shows how changes in output generate magnified changes in investments.

In the 1940s the fiscal policy of Keynesian economics began to take shape in the form of *three ways to full employment* – an increase in government purchases of goods and services with an attending budget deficit, a reduction of taxes, which would require a larger deficit, and an increase in equal amounts both of government expenditures for goods and services and of taxes, with a balanced budget. The respective merits of the three policies formed a subject of wide ranging discussions, in which attention was also drawn to the factors that might limit the effectiveness of fiscal policy[593].

19.5 Economics before and after Keynes[594]

Before Keynes, economic analysis was concerned with the efficient allocation of resources, a matter treated under the heading of price theory, value and distribution, and partial and general equilibrium. After Keynes, these theories were supplemented by the analysis of the determination of total output, yielding income and employment theory.

Before Keynes, by far the greater part of economic theory had only a formal validity, that is, it could claim logical consistency on the basis of certain assumptions but did not lend itself to empirical testing. Virtually all, microeconomic concepts were ex ante notions which reflected subjective estimates of the future. They were not suited to statistical verification. After Keynes, much economic theory became operational in

[593] ibid., pp. 610-611.
[594] This section is based on Spiegel, pp. 611-613.

the sense of being developed in terms that lent themselves to empirical measurement. The rise of macroeconomics, consisting of such ex post aggregates as the various national income concepts, stimulated the development of national economic accounting. Governments throughout the world assumed a task in which private scholarship had pioneered – the systematic derivation of the various national income concepts and their regularly recurring estimation.

Before Keynes, economic policy primarily aimed at the stabilisation of prices and was pursued principally in the form of monetary policies. These, in conjunction with wage cuts, were also considered suitable to relieve unemployment and to bring about full employment, a position interpreted in terms of an equilibrium toward which the economy would tend to move in line with Say's law. After Keynes, the reliance on the operation of automatic forces that would secure full employment vanished, and the stabilisation of employment emerged as a goal of public policy. After Keynes, it became recognised that the national income might be in equilibrium while unemployment persisted. In view of the limitations of purely monetary policies, these were supplemented by fiscal policy. Wages were considered as a factor affecting cost as well as demand, and wage cutting and deflation were no longer relied upon as means to full employment.

Before Keynes, a strong tradition in economic thought considered money as neutral in the sense of not affecting the level of output. After Keynes, variations in cash balances were associated with variations in the rate of interest. Since the latter was an important determinant of investment in Keynes's theory and since investment was a strategic variable affecting the levels of employment and income, the latter were indirectly linked with money.

Before Keynes, the time-honoured tradition had elevated thrift to an absolute virtue, which was to be practiced at\ all times by private citizens and public authorities alike. Fiscal propriety was interpreted as requiring a balanced budget. Keynes taught that expenditure generates income and employment, and after him it became recognised that when income and employment are unduly low, public or private thrift ceases to be a virtue. With Keynes, the view that under certain conditions planned savings might be redundant and self-defeating, a view hitherto held by only a small number of economic *heretics*, became respectable, and Keynes himself attempted to rescue the memory of *the brave army of heretics*, among whom he included Mandeville, Malthus, Gesell and Hobson.

Keynesian economics, with its rich harvest of new ideas nevertheless had its limitations. Keynes's theory of output, though ostensibly a general one, was primarily relevant to conditions in which the economy operated at less than full capacity. Under conditions of full employment, such tools of analysis as the multiplier would register what were not real but monetary changes. Under such conditions the old-line micro-economic approach, with its emphasis on the allocation of resources, would again move closer to the centre of the stage, monetary policy would be rediscovered as one of the means to cope with inflation, and thrift would be hailed as a virtue. Furthermore, the aggregative economics of the *General Theory*, especially when evolving into a fiscal policy of commercial Keynesianism, did not constitute a conceptual apparatus from which could readily be drawn questions and answers relevant to such problems as the quality of the ecological environment and the emerging issues of the cities and the race.

19.6 Evaluation[595]

It is difficult to appreciate the bombshell effect of the *General Theory*. A myth has grown up I subsequent years that it was Keynes' radical views on economic policy that constituted the break with orthodoxy. According to this myth, all economists and governments stood helpless in the face of the 1929 crash, advocating balanced budgets and cut in money wages, or else letting things run their course; only Keynes held out a realistic and effective solution to the Great Depression. But at a glance, the *General Theory* shows that it is severely theoretical book and that no more than 25 pages of it are devoted to the policy implications of the argument: it is a book about disagreements in the theory of how the economy works and not about disagreements of what ought to be done about the economy. In fact, many orthodox economists years before Keynes had advocated public works, monetary expansion and counter-cyclical budgetary deficits to deal with the unemployment.

What was new about Keynes was, first of all, the tendency to work almost exclusively with aggregate, macroeconomic variables and to reduce the entire economy to three markets for goods, bonds and labour; secondly, to concentrate on the short period and to confine the analysis of the long period, which had been the principal analytical focus of his predecessors, to asides; and thirdly, to throw the entire weight of adjustments to

[595] This section is based on Blaug, *Great Economists*, pp. 106-109.

changing economic conditions on output or income rather than prices. Equilibrium for the economy as a whole now involved ‘unemployment equilibrium’, and the introduction of this apparent contradiction in terms involved profound change in the vision of contemporary economists who had always believed that competitive forces do ultimately drive the economy automatically toward a steady state of full employment.

The gradual but increasingly widespread acceptance of most of Keynes’ views in the immediate years after the Second World War raised Keynesianism for a while to the position of a prevailing orthodoxy. Price theory and microeconomics took second place to macroeconomics; long period analysis virtually disappeared, and demand management [the view that the government can achieve full employment and price stability by fine-tuning of the economy] commanded universal assent. In recent years, however, all these elements of Keynesianism have been repeatedly attacked and his star has definitely begun to wane. Even so, Keynes remains one of the three or four most influential economists that ever lived.

XX. POST-KEYNESIAN ECONOMICS

During the 1940s, 1950s and 1960s many economists have improved on the ideas of Keynesian economics. A few openly opposed it and in the late 1970s and 1980s new type of economics was being advocated.

The most important influence of the Keynesian economics was its synthesis, or integration, into the general body of accepted economic principles. The greatest influence in this was Professor Paul Samuelson's *Principles of Economics*. The book explained the ideas and principles of Keynesian economics, not to the exclusion of, but together with the orthodox principles of evolving neo-classical economics. Samuelson's book was widely used, and soon widely imitated. Others were also expounding their anti-Keynesian stand. Their leader was Professor Milton Friedman of the University of Chicago. These two giants in the area of economics have had profound effects on the growth of the field of economics. Both of them have won the Nobel Prize for Economic Sciences. For a better appreciation of their influence, a brief background of these two economic is given below.

Professor Paul Anthony Samuelson (1915 -) was born in Indiana and educated at the universities of Chicago and Harvard. He was appointed professor of economics at the Massachusetts Institute of Technology in 1940 [emeritus professor since 1985]. He worked for the US Treasury for seven years after World War II and has acted as a consultant to many government bodies. Much of his work has appeared in Journals. His publications include *Foundations of Economic Analysis* (1947), *Economics* (1948) and *Linear Programming and Economic Analysis* [with R. Dorfman and R.M. Solow] (1958). Professor Samuelson developed the Heckscher-Ohlin principle by showing how an increase in the price of a commodity can raise the income of the factor of production, which is used most intensively in producing it. This led to his formulating the *factor price equalisation theorem,* which states the conditions under which, as *free trade* in commodities narrows differences in commodity prices between countries, in so doing the prices (incomes) of factors of production are also brought into line. In other words, free trade is a substitute for the free mobility for the factors of production. Professor Samuelson has made important contributions to the development of mathematical economics, general equilibrium theory and the theory of consumer behaviour. To free the last from what he considered the to be the constraint of the traditional concept of utility, he invented *revealed preference*. In macroeconomic

theory he was the first to formulate the interaction between the accelerator and the multiplier in the article he wrote in 1939. Moreover, he was a leading figure on the side of neo-classical economics in the debate with the *Cambridge school* regarding the integration of classical microeconomics and modern macroeconomics in growth theory[596].

Professor Milton Friedman (1912 -) was born in New York and educated at the universities of Chicago and Columbia. Professor Friedman is a leading member of the *Chicago School*. He worked for the Natural Resources Commission in Washington, followed by research at the National Bureau of Economic Research. During World War II he served in the Tax Research Division of the US Treasury and then the Statistical Research Group of the Division of War Research, Columbia University. He was appointed Professor of economics at the University of Chicago in 1948 and he served there until his retirement in 1979. In 1976 he was awarded the Nobel Prize in Economics by the Royal Swedish Academy of Sciences. His main published works in economics include *Taxing to prevent Inflation* (1943); *Essays in Positive Economics*(1953); *A Theory of Consumption Function* (1957); *A Program for Monetary Stability* (1960); *Price Theory* (1962); *A Monetary History of the United States 1867-1960* (1963); *Inflation: Causes and Consequences* (1963); *The Great Contraction* (1965); *The Optimum Quantity of Money* (1969); *A Theoretical Framework for Monetary Analysis* (1971), *An Economist's Protest: Columns in Political Economy* (1975); *Money Mischief* (1992); and With Anna J, Schwartz he wrote *Monetary Trends in the United States and the United Kingdom* (1982). With his wife Rose, whom he married in 1938, he wrote *Free. To Choose, A personal Statement* (1980), and *Tyranny of the Status Quo* (1984).

Friedman is known for his studies on the influence of the quantity of money [bank deposits and currency] in an economy on the level of production. He is strong believer in the efficiency of the market and minimal government interference. In his view, changes in the money supply cause changes in the level of production, not the other way round, and controlling the money supply is the most effective way to tackle inflation. These ideas were a major influence on the government economic policy in Britain under Margaret Thatcher and the USA under Ronald Reagan during the 1980s. he also proposed a theory of permanent income, in which an individual's

[596] *The Penguin Dictionary of Economics,*1988; Market House Books, Ltd. (1999) *Who is Who in the Twentieth Century,* Oxford University Press.

spending decisions depend not on his or her wealth at the time but on expected lifetime wealth[597].

Friedman has made contributions to the theory of distribution, arguing for an approach in which high incomes are regarded as a reward for taking risks. He has also been a leading defender of the Marshallian tradition of microeconomics and made a methodological defence of classical economics that stimulated controversy for a decade. His permanent – income-hypothesis was also an important contribution to the theory of the consumption function. His main work, however, has been on the development of the quantity theory of money and its empirical testing. He has extended the Fischer equation to include other variables such as wealth and rates of interest, and has made statistical tests to attempt to measure the factors determining the demand for money hold. Friedman has advocated strict control of the money supply- preferably in accordance with a simple rule as to how much growth will e allowed year by year – as a means of controlling inflation. His view that it is not desirable to fine-tune the economy using stabilisation policy has to a large extent been accepted, but in the world of economic theory Friedman's findings have been overshadowed by the more elegant route to similar conclusions based on rational expectations, and associated with new classical economics[598].

Rational Expectations and Supply-Side Economics

During the 1970s and 1980s two new theories were gaining increasing acceptance: the theories of *rational expectations* and *supply-side economics*. Both of these theories work within the basic assumptions of neo-classical economics and both challenge the theoretical propositions of Keynesian economics.

In 1995 Robert Lucas won the Nobel Prize for his seminal work on the rational expectations hypothesis. Described by the *Economist* [March 30, 1996] as the most influential macroeconomist of his generation, Lucas's theories have doubtless undermined traditional Keynesian economics and paved the way for new classical economics. This highly mathematical theory dominated all economic thought in the 1970s and early 1980s and it appeared that it would replace all Keynesian thinking.

[597] ibid.,
[598] ibid.,

The citation from the Royal Swedish Academy of Sciences states: the Academy has decided to award the Nobel Prize in Economics to Professor Robert E. Lucas, of the University of Chicago, *for having developed and applied the hypothesis of rational expectations, thereby having transformed macroeconomic analysis and deepened our understanding of economic policy.*

The Nobel Prize Press Release further documented that Robert Lucas is the economist who has had the greatest influence on macroeconomic research since 1970. His work has brought about a rapid and revolutionary development: application of the rational expectations hypothesis emergence of an equilibrium theory of business cycles, insights into the difficulties of using economic policy to control the economy, and possibilities of reliably evaluating economic policy using statistical methods. In addition to his work in macroeconomics, Lucas's contributions have a very significant impact on research in several other fields[599].

The central concept of supply side economics is that tax cuts cause economic growth. Tax cuts allow entrepreneurs to invest their tax savings, which creates higher productivity, jobs and profits. This, ironically, allows the entrepreneur and his new workers to pay even more taxes, even at lower rates.

The supply-side is a simple one, and makes a popular political message. However, it is interesting that mainstream economists, even the conservative ones, almost universally reject supply-side theory. In the early 1980s, the influential and multi-partisan American Economics Association had 18,000 members. Only 12 called themselves supply-side economists[600]. During the 1980 presidential campaign George Bush called supply-side economics *voodoo economics!* and yet he was doing so with a full backing of the America's economic community. Thus, it is obvious that *conservative* does not necessarily equate to supply-side economics, as mainstream conservative economists generally believe that tax cuts should be accompanied by spending cuts – that is, fiscal responsibility. Supply side economists believe that taxes should be cut – period. Spending cut and

[599] It is important to note that there are critics who do not believe that the theory would be sustainable. They state that rational expectation although still widely admired, has lost currency in academia. See http:// www.huppi.com/kangaroo/L-chimain.htm

[600] James Carville, *We're Right, They're Wrong: A Handbook for Spirited Progressives*, New York: Random House, 1996., p. 12.

deficits, they believe, are not important considerations.[601] However, it may be pointed out that an unusually high percentage of supply-siders of the 1980s were not economists at all but rather journalists without any formal training in the discipline.

Where does "supply-side economics" fit in the Keynesian - monetarist controversy? It does not, really. But it makes the Keynesian prescription look somewhat irrelevant. The Keynesian economics focuses on "demand side" economics.

[601] http:// www.huppi.com/kangaroo/23More.htm

List of Nobel Prize Laureates in Economics 1969 – 2001.

1969. Ragnar Frisch (Norway) and **Jan Tinbergen** (Netherlands), *for having developed and applied dynamic models for the analysis of economic processes.*

1970. Paul A. Samuelson (USA), *for the scientific work through which he has developed static and dynamic economic theory and actively contributed to raising the level of analysis in economic sciences*.

1971. Simon Kuznets (USA), *for his empirically founded interpretation of economic growth, which has led to new and deepened insight into the economic and social structure and process of development*.

1972. Kenneth J. Arrow (USA) and **Sir John R. Hicks** (UK), *for their pioneering contributions to general economic equilibrium theory and welfare theory*

1973. Wassily Leontief (USA), *for the development of the input-output method and for its application to important economic problems*.

1974. Gunnar Myrdal (Sweden) and **Friedrich A. von Hayek** (UK), *for their pioneering work in the theory of money and economic fluctuations and for their penetrating analysis of the interdependence of economic, social and institutional phenomena.*

1975. Leonid V. Kantorovich (USSR) and **Tjalling C. Koopmans** (USA), *for their contributions to the theory of optimum allocation of resources*

1976. Milton Friedman (USA), *for his achievement in the fields of consumption analysis, monetary history and for his demonstration of the complexity of stabilization policy*

1977. Bertil Ohlin (Sweden) and **James E. Meade** (UK), *for their path breaking contributions to theory of international trade and international capital movements*

1978. Herbert A. Simon (USA), *for his pioneering research into the decision-making process within economic organizations*

1979. Sir Arthur Lewis (UK) and **Theodore Schultz** (USA), *for their pioneering research into economic development research with particular consideration of the problems of developing countries*

1980. Lawrence R. Klein (USA), *for the creation of econometric models and the application to the analysis of economic fluctuations and economic policies*

1981. James Tobin (USA), *for his analyses of financial markets and their relations to expenditure decisions, employment, production and prices*

1982. George J. Stigler (USA), *for his seminal studies of industrial structures, functioning of markets and causes and effects of public regulation*

1983. Gerard Debreu (USA), *for having incorporated new analytical methods into economic theory and for his rigorous reformulation of the theory of general equilibrium*

1984. Sir Richard Stone (UK), *for having made fundamental contributions to the development of systems of national accounts and hence greatly improved the basis for empirical economic analysis*

1985. Franco Modigliani (USA), *for his pioneering work in saving and financial markets*

1986. James M. Buchanan (USA), *for his development of the contractual and institutional basis for the theory of economic and political decision-making*

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